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ARTICLES

SAVINGS FOR THE POOR: THE HIDDEN BENEFITS OF ELECTRONIC BANKING: A REVIEW AND RESPONSE

JOSEPH A. SMITH, JR.

Fairness in meeting the financial needs of the poor and working poor is a matter of great current interest to financial services firms, regulators and advocates for the poor. The issue manifests itself in the public domain in two distinct ways: (i) legislative and regulatory action regarding predatory lending; and (ii) congressional proposals to use public funds to create incentives for financial institutions to provide services to people and communities in need. However the fairness issue is addressed, its gravamen is that the poor and working poor do not have adequate access to financial services. To the extent that such persons have access to financial services, it is at a price that is substantially greater than the price for wealthier persons. This issue remains in the public arena nearly a quarter of a century after the adoption of the Community Reinvestment Act of 1977 (CRA), which was enacted to address the credit needs of low and moderate income communities. If the fairness issue, in its various manifestations, is

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not intractable, it is the next worst thing.

Michael A. Stegman, Chair of the Curriculum in Public Policy Analysis and Director of the Center for Community Capitalism at the University of North Carolina at Chapel Hill, addresses important aspects of this issue in his recent book, *Savings for the Poor: The Hidden Benefits of Electronic Banking.* Professor Stegman comes to this task well prepared, having served as Assistant Secretary for Policy Development and Research at the U.S. Department of Housing and Urban Development before returning to Chapel Hill in July of 1997. *Savings for the Poor* is not merely a study of the U.S. Department of Treasury's implementation of the Congressional mandate that welfare payments be made by electronic means. It also argues for an overhaul of welfare policy "from entitlement programs to policies that promote work, self-sufficiency, and wealth accumulation."

*Savings for the Poor* is a well-written and serious work on an important issue of public policy. It deserves the careful attention of and a serious response from those interested in the problem of poverty and the capacity of our banking institutions to address it. An attempt at such a response is set forth below. Section I reviews the book in broad outline; Section II comments on the book's treatment of financial institutions; and Section III assesses the book as a brief for a change in public policy.

I. REVIEW OF BOOK

*Savings for the Poor* chronicles the efforts by the Treasury Department to implement "EFT '99," a legislative mandate contained in the Debt Collection Improvement Act of 1996. The mandate required that the recipients of a number of federal benefit programs receive their payments via electronic means.

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5. Id. at 2.
6. See infra notes 6-38 and accompanying text.
7. See infra notes 39-56 and accompanying text.
8. See infra notes 57-61 and accompanying text.
Professor Stegman points out that the original policy rationale of EFT '99 had more to do with governmental efficiency than with bringing the poor and working poor into the financial mainstream. In the public sector, as in private enterprise, the cost of transactions handled electronically is a fraction of those affected through paper documents. While the logistical challenges of setting up a "non-paper" payment system were significant, "the cost savings to the government—only 2 cents for an EFT payment compared to 43 cents for a check payment—were deemed substantial enough to justify the transition."

Cost aside, the Treasury also had to deal with the fact that the use of electronic means to make benefit payments required that the recipient have a bank account, which a substantial number of benefit recipients did not have. Given this circumstance, implementation of EFT '99 required that benefit recipients without bank accounts be brought into the banking system. Savings for the Poor recounts the Treasury's attempt to achieve this objective and the response of the financial services industry, advocates for the poor and the poor themselves, to this attempt.

A. The Stakeholders

1. "Unbanked"

Savings for the Poor sets the stage for its presentation of Treasury's efforts to implement EFT '99 with a detailed discussion of the stakeholders in this activity, beginning with the "unbanked." The unbanked are those Americans who do not have a bank account. As pointed out by Professor Stegman, this group is larger than the target market for EFT '99:

Nationwide, an estimated 13 percent of U.S. families—including up to 10 million federal benefit

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10. STEGMAN, supra note 4, at 5-7.
11. Id. at 5.
12. Id.
13. Id. at 7 (citation omitted).
recipients—currently have no bank accounts. Among federal benefit recipients, the unbanked are more likely to be people of color, younger, and poorer than other benefit recipients.

The universe of unbanked Americans, both recipients and non-recipients of federal benefits, represents one third of all minority households. One in four renters, one in six of those under 35 years of age, and 15 percent of the working poor—families earning between $10,000 and $25,000—do not have checking accounts. Among welfare recipients, as many as three out of four are estimated to be without a bank account.\(^4\)

While much in the quoted passage will not surprise a reader even casually familiar with the issues confronting the poor and working poor, the numbers are striking nonetheless. The group described above is a substantial one, and the absence of banking relationships subjects them to inconveniences and costs that worsen already strained circumstances.

After describing the unbanked, Professor Stegman analyzes the factors that most affect the poor and working poor in their relationships, or lack thereof, with financial institutions. Based on recent studies of the unbanked, he presents a sophisticated analysis that shows how various combinations of variables interact to keep people out of the banking system. Many of the variables will come as no surprise to the reader: age, race, gender, level of education, citizenship status, language proficiency and income level.\(^5\) By establishing a base case for a particular subgroup of the unbanked and then altering one or a few variables, the analysis isolates the impact of the variables on the likelihood of being unbanked.\(^6\) For example:

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14. *Id.* at 8.
15. *Id.* at 24-30.
(the likelihood that) a non-Hispanic white male, age 39, with 12.73 years of education and $22,000 in annual income, who is a renter and a U.S. citizen, is unmarried, reads and speaks English well, works either full- or part-time, lives in a low-poverty neighborhood, and lives or works near a bank... would be unbanked is just 6%. If the base case were an Asian male... but all other characteristics were the same, the probability of the individual being unbanked would fall by half, to 3 percent.... If Hispanic is substituted for non-Hispanic white, and all other variables are held constant, the probability of the individual being unbanked increases from 6 to 7%, a statistically insignificant change.... The probability increases to 10% for an individual with eight years of education and falls steadily as education level rises.... The probability of being unbanked also varies inversely with income.... When the base case individual’s income is $4,000 instead of the sample mean of $22,000, the probability of being unbanked more than doubles from 6 to 13 percent.

The research in Savings for the Poor also highlights other important factors that affect the unbanked, including cultural issues and sources of information. For example, the unbanked from Central and South America associate banking in their home country only with the rich, and in this country with difficulties of language and custom that make the transaction of business difficult. Furthermore, research shows that television is most likely the source of information about financial services among the unbanked—a fact not lost on “non-traditional” firms, such as check

17. Id. at 30-31.
18. Id. at 34.
19. Id. (citation omitted); Squeezing the Banks, ECONOMIST, Sept. 2, 2000, at 53 (discussing to the phenomenon of the unbanked in England as arising from: (i) conflict of banking with the tenets of Islam; (ii) the need for a driver’s license or other identification documents; and (iii) association of banking with the rich only).
cashers, that use television and personal networks as their primary marketing tool.\textsuperscript{20}

At the conclusion of the chapter on the unbanked, Professor Stegman points out that “[f]or EFT to succeed will require more than product development; it will also require new marketing strategies.”\textsuperscript{21} These strategies, to be successful, should be based on the market analysis discussed above. Professor Stegman’s analysis of the unbanked is complex and requires careful attention. The effort required is well worth it because it gives the reader a clear look at the unbanked and the reasons for their circumstances.\textsuperscript{22} \textit{Savings for the Poor} is a valuable resource for any person or institution that intends to market financial services to the poor and working poor in general, and the unbanked in particular.

2. Financial Services Industry

Professor Stegman then discusses the financial services industry, both traditional banks and their “non-bank” competitors. With regard to banks:

\[ \text{the interplay of many factors—among them the deregulation of interest rate ceilings in the 1980s, new technology, and growing competition from nondepository institutions—has led to a significant decline in the number of financial institutions in the United States and has driven banks to charge for services they formerly subsidized with cheap, regulated deposits.}\textsuperscript{23} \]

\textsuperscript{20} \textit{STEGMAN, supra} note 4, at 34.

\textsuperscript{21} \textit{Id.} at 36.

\textsuperscript{22} Among the genuinely disheartening findings of the research is that African-Americans are the group most likely to be unbanked, even after controlling for other factors. \textit{Id.} Professor Stegman asserts that this finding “reinforces the idea that, despite legal gains, powerful forms of racial discrimination remain that disadvantage blacks relative to other racial and ethnic groups.” \textit{Id.} at 37. Those who disagree with this conclusion, including the author of this article, need to do some work to understand and correct this unsettling fact.

\textsuperscript{23} \textit{Id.} at 2.
Professor Stegman associates the aforementioned factors with increases in fees,\textsuperscript{24} closing of branches in poor neighborhoods\textsuperscript{25} and a related increase in the number of the unbanked.\textsuperscript{26} He goes on to discuss how developments in information processing and telecommunications, such as the telephone and personal computer, have increased the delivery channels available to banks and their non-bank competitors to attract and serve customers.\textsuperscript{27} While recognizing the potential that technology presents in terms of meeting the needs of the poor by dramatically reducing the cost of providing services, \textit{Savings for the Poor} observes that the cost of such technology may be beyond the means of the poor and working poor. This effect is another aspect of the "digital divide."\textsuperscript{28}

Because banks cannot serve the poor and working poor profitably, other "non-traditional" firms, such as check cashing firms, step in to provide those services. Professor Stegman points out that such firms are able to do so by operating in less expensive locations for substantially greater hours with a sales-oriented culture that shows a greater appreciation for the culture and preferred sources of information of the target market.\textsuperscript{29} More important to profitability, the fees, charges and interest rates charged by non-traditional firms are materially higher than those charged by traditional banks.\textsuperscript{30} This aspect of the business practices of non-traditional firms is a source of continuing conflict with advocates for the poor and working poor, including the debate over EFT '99, and the current debate over predatory lending.

\begin{footnotesize}
\footnote{24. \textit{Id.} at 3.}\footnote{25. \textit{Id.} at 2.}\footnote{26. \textit{STEGMAN, supra} note 4., at 17.}\footnote{27. \textit{Id.} at 38.}\footnote{28. \textit{Id.} at 40 (citation omitted).}\footnote{29. \textit{Id.} at 64.}\footnote{30. \textit{Id.} at 66.}\end{footnotesize}
3. Advocates for the Poor

Advocates for the poor are not directly treated in *Savings for the Poor*; rather they are portrayed by what they advocate and, in this context, by what they oppose. Professor Stegman notes:

[because of] serious questions about consumer protection, access to technology and services, and costs... the move to electronic benefits delivery is opposed by some powerful consumer groups and community development advocates, who believe EFT '99 compels unbanked recipients into relationships that they have already determined are detrimental to themselves for the federal government’s direct benefit.\(^3\)

While these advocates were not the primary facilitators in the implementation of EFT '99, their activities were material in determining its outcome. Professor Stegman makes clear that support from community activists is crucial if the optimum use of EFT '99 and related savings incentives is to become a reality.\(^2\) They are clearly a target audience of this book.

B. Implementation of EFT '99

Having set the stage with its discussion of the stakeholders, *Savings for the Poor* then reviews the implementation of EFT '99.\(^3\) The Office of the Comptroller of the Currency’s (OCC) rule-making process began in November 1996. The EFT '99 account’s attributes were not published for comment until November 1998 and agreements with financial institutions to actually offer the

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31. *Id.*
32. STEGMAN, supra note 4, at 10.
33. *Id.* at 83-112.
account were not completed until seven months later. Although EFT '99 began as a mandatory payment mechanism for benefit recipients offered on a competitive basis through the banking system, it became a voluntary payment system for benefits recipients provided through a system of accounts that were essentially mandatory as to terms and conditions.

What happened? Why did the nature of the program change so drastically? Through the rulemaking process for EFT '99, the Treasury Department attempted to craft a program that would harness the competitive forces of the marketplace to serve the poor and working poor with the agreement of the stakeholders, financial institutions, community advocates and the poor.

The rulemaking process became a long and complex negotiation among the stakeholders involving every aspect of EFT '99. Traditional banking institutions were less enthusiastic about offering the product than expected and had serious concerns about the fees that could be charged, the costs of administration (particularly compliance with consumer regulations) and the loss of control over the opening and closing of accounts. Nontraditional competitors wanted to participate, but they intended to charge fees that were unacceptable to consumer advocates. Consumer advocates sought to limit the fees that financial services intermediaries could charge and were critical of the mandatory nature of the program.

As a consequence of this negotiation, the Treasury relented with regard to several aspects of the program. Namely, the mandatory nature of the program was changed so that benefit recipients could elect whether to receive payments electronically, the institutions allowed to offer the EFT account were limited to traditional banks and the Treasury circumscribed the terms, fees and charges related to the program. Professor Stegman assesses this outcome as follows:

34. Id. at 84.
35. Id. at 85-86.
36. Id. at 96.
37. Id. at 99-100.
While Treasury's vision of bringing millions of unbanked recipients into the financial mainstream remains a powerful one, there is no question that EFT '99 has been severely compromised during the rulemaking process. ... The cumulative effect of Treasury's decisions has been to significantly lengthen the transition to EFT, greatly reduce the number of unbanked who will be brought into the financial mainstream through the EFT process, and deflate the economics of ETAs by reducing their market size.\footnote{38. STEGMAN, supra note 4, at 118. This conclusion is confirmed by a recent report that about 5,000 people have opened accounts under EFT '99 and that, although approximately 600 banks, thrifts and credit unions are offering such accounts, most of the current customers have accounts with one institution, Banco Popular de Puerto Rico. Lisa Daigle, E-Benefit Accounts Fail to Gain Broad Usage, Big-bank Efforts Could Revive Program in '01, AM. BANKER, Dec. 12, 2000, at 1.}

The foregoing is not to say the EFT '99 is a failure. Professor Stegman points out that EFT '99 has been a catalyst for a grassroots campaign of financial education of the poor and working poor.\footnote{39. STEGMAN, supra note 4, at 84.} This campaign has not been contained at federal level. \textit{Savings for the Poor} provides a description of a number of effective efforts at the state level through electronic benefit transfer (EBT) systems that do not require the opening of a bank account. Recipients receive a card that entitles them to "draw" against the value of their benefits, either through merchants of goods purchased or, in some instances, cash withdrawals from ATMs.\footnote{40. Id. at 114.}

\textit{Savings for the Poor} then presents an "EFT action agenda" that proposes a refocusing of public policy regarding the poor and working poor to emphasize the accumulation of wealth.\footnote{41. Id. at 158.} This agenda includes, among other things: (i) enacting a national individual development account program to create incentives for saving; (ii) altering administration of the Community Reinvestment Act to increase the possible credit for service
offered in providing individual development accounts and electronic funds transfer payments; and (iii) regulating check cashing operations regarding government benefits payments.

The book ends with a clear statement of the author's view that it is a political, social and moral necessity that America apply the tools of technology to serve the needs of the poor and working poor.

II. TREATMENT OF FINANCIAL INSTITUTIONS

Bankers are an important subject of *Savings for the Poor*, both in terms of what they have and have not done for the poor and working poor. Professor Stegman identifies the closing of traditional bank branches in low and moderate income neighborhoods and increases in service charges, as contributors to the growth in number of the unbanked, more in sorrow than in anger. He attributes these actions to deregulation and increased competition. Describing Treasury's reduction of expectations for EFT '99 in September 1997, he says that Treasury was “stung by the industry’s indifference” to the program. In a speech at that time, John Hawke, then Treasury Undersecretary, remarked:

> Industry response to EFT ‘99 has been disappointing so far. I have heard far more in the way of complaints about the possible costs of EFT ‘99 for banks than about the need to change public opinion about electronic payments. I also find, to my great surprise, that almost eighteen months after the EFT ‘99 law was enacted, there are some bankers who have never even heard of it, and many who have only the vaguest idea of what it is about.

In light of these comments, what is one to think of the bankers? With regard to their conduct toward the poor and working poor, are banks: (i) morally obtuse or worse; (ii) too

42. Id. at 91-92.
43. Id. at 92.
dumb to recognize a business opportunity when they see it; or (iii) acting rationally in the face of a difficult market? Although Professor Stegman does not indicate which he thinks is the case, his proposal to revise and extend the CRA suggests that he believes that bankers need regulatory prodding to play the role he thinks they should in addressing the needs of the poor and working poor.

For the reasons set forth below, I submit that the bankers acted rationally towards EFT ‘99 in the face of a difficult market. I speak with some experience in this regard, having served as general counsel of a bank holding company for eight years, including the period of time covered in Savings for the Poor. During that time, my colleagues and I attempted to extend the firm’s business to the poor and working poor in a way that was consistent with our overall business objectives, including profitability. For reasons of institutional values and the practical consideration that at a minimum a satisfactory CRA rating was required to grow by acquisition, we did our best to make the loans and provide the other services necessary to meet the needs of the communities we served, including a number of low and moderate income communities. In the main, I believe we succeeded; however, such success was not easy and brought with it only marginal economic returns to the corporation. Because the profitability of serving the poor is central to the banks’ attitude toward EFT ‘99 and other community development activities, a discussion of what it means to be profitable is set forth below.

The financial services companies discussed in Savings for the Poor are private corporations owned by shareholders and financed through capital markets. In seeking capital themselves, these corporations compete with a wide variety of other

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44. The author acknowledges that this statement, while true, is not complete. Banking organizations as a rule are chartered on an undertaking to meet public convenience and necessity and benefit from the public insurance of deposits through the FDIC. This aspect of the banking franchise leads many commentators, including Professor Stegman, to point out that service to the poor and working poor “goes with the territory,” which position is affirmed by the continued application of the CRA. That having been said, the point remains that banks can only meet their social obligations and applicable regulatory requirements, including satisfactory capital, earnings and liquidity, if they are profitable.
investments available to investors and lenders. To attract capital, each of these firms seeks to obtain a positive risk-adjusted return by earning net operating profit after taxes (NOPAT) that exceeds the firm's cost of capital. This excess, or "economic value added" (EVA) is the true economic profit generated by the firm.\textsuperscript{45} Achievement of positive EVA creates value for shareholders by increasing the value of their holdings; failure to do so has negative consequences for the firm, its shareholders and, more and more frequently, management.\textsuperscript{46}

Other things being equal, profit maximization tends to disfavor services to the poor and working poor because such services are generally in materially smaller amounts than those to the more affluent. Schedule 1 analyzes this problem with regard to three hypothetical loans with various principal amounts: Loan 1, $1,000; Loan 2, $50,000; and Loan 3, $200,000.\textsuperscript{47}

\textsuperscript{45} EVA is a registered trademark of Stern, Stewart & Co. The definitive work on this concept is G. BENNETT STEWART, THE QUEST FOR VALUE: A GUIDE FOR SENIOR MANAGERS (1991).

\textsuperscript{46} It is interesting to note that one bank executive, quoted with approval by Professor Stegman, has left the firm with which he was associated at the time of the quote as a result of a "management reorganization." A second executive, also quoted with approval, has experienced a reduction in role arguably related to corporate performance. Furthermore, an institution mentioned approvingly in \textit{Savings for the Poor} has recently been the subject of a control contest. These circumstances suggest, if nothing else, that an institution must generate an adequate return to shareholders in order to retain the right to meet community needs.

\textsuperscript{47} As a member of the reserve army of the innumerate, the author has attached Schedules 1 and 2 to this article with due humility. The calculations are of the back-of-the-envelope variety and are intended to highlight the issues under consideration rather than as virtual reality. This caveat having been given, I believe the Schedules are generally correct.
<table>
<thead>
<tr>
<th></th>
<th>LOAN 1</th>
<th>LOAN 2</th>
<th>LOAN 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Principal Amount</strong></td>
<td>$1,000</td>
<td>$50,000</td>
<td>$200,000</td>
</tr>
<tr>
<td><strong>Coupon (@ 8%)</strong></td>
<td>80</td>
<td>4,000</td>
<td>16,000</td>
</tr>
<tr>
<td><strong>Cost of Funds</strong></td>
<td>(45)</td>
<td>(2,250)</td>
<td>(9,000)</td>
</tr>
<tr>
<td><strong>Origination Fee</strong></td>
<td>10</td>
<td>500</td>
<td>2,000</td>
</tr>
<tr>
<td><strong>Gross Margin</strong></td>
<td>45</td>
<td>2,250</td>
<td>9,000</td>
</tr>
<tr>
<td><strong>Expenses (@ 50%)</strong></td>
<td>(22)</td>
<td>(1,125)</td>
<td>(4,500)</td>
</tr>
<tr>
<td><strong>Tax (@ 30%)</strong></td>
<td>(7)</td>
<td>(338)</td>
<td>(1,350)</td>
</tr>
<tr>
<td><strong>NOPAT</strong></td>
<td>16</td>
<td>788</td>
<td>3,150</td>
</tr>
<tr>
<td><strong>Capital Charge</strong></td>
<td>13</td>
<td>650</td>
<td>2,600</td>
</tr>
<tr>
<td><strong>Economic Value Added</strong></td>
<td>3</td>
<td>138</td>
<td>550</td>
</tr>
</tbody>
</table>

Schedule 1 assumes the following: each loan has equal revenues (a coupon of 8% and an origination fee of 1%); equal associated expenses; 90% of the loans are funded by bank borrowings at 5%; the remainder of the loan is funded by lender's equity. It is also assumed that no difference exists in the risk between the three loans and accordingly each has a 13% cost of capital. Based on the foregoing assumptions, each of the loans described on Schedule 1 is "profitable," in that each results in positive NOPAT and generates a positive EVA. That being said, Loan 3 generates substantially greater margin and EVA than either Loan 1 or Loan 2. Furthermore, loans to first-time or unsophisticated borrowers are costlier and riskier than larger loans.

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48. Assumes 90% of Principal Amount is funded at 5%.
49. One percent of principal amount.
50. Capital allocated to the loan (10%) times 13% capital charge.
to more seasoned and wealthier borrowers, such as Loan 3.\footnote{I am certain that those experienced with lending to the poor and working poor will argue with me about issue of risk. The good news is that a growing body of evidence on the performance of loans to this segment of the market suggests, at least in the affordable housing portfolios generated by banks, that there may not be a significant additional risk of default. Regularity of payment may be another matter, but as the accumulation of evidence continues and time passes, we will be more knowledgeable on this issue. For one interpretation of the currently available data, see Howard Husock, \textit{Busting up Neighborhoods}, FORBES, Sept. 18, 2000, at 36. In this article, the author, a Contributing Editor of the Manhattan Institute's CITY JOURNAL, argues for tougher lending standards as a way to protect the investments of poor and working poor people in their neighborhoods.} Adjusting for origination costs (certainly) and risks (probably) would tip the balance further in favor of Loan 3. Adding even a nominal charge for processing would drive Loan 1 into “negative EVA;” if such processing cost were over $100 per loan, Loan 2 would reduce or eliminate its EVA contribution. If the capital charge for the smaller loans were increased to reflect greater risk, their EVA contribution would certainly be eliminated.

Based on the foregoing, the economic incentive to the lender is to make larger loans rather than smaller ones since, for the same amount of work, the lender generates significantly greater gross margin and EVA. In order to generate a maximum return to the firm, incentive compensation to originators for large loans is substantially greater than those for small ones. This conclusion is supported by actual experience, particularly in the area of home mortgage lending. As a rule, mortgage originators are compensated on production volume and it takes a significant amount of coaxing to convince them to originate small loans generally, and non-conforming small loans, in particular.

A similar analysis can be applied to the provision of services to the poor and working poor through the opening of branches where they live. Schedule 2 estimates of the cost of operating a branch to determine the level of activity necessary to operate profitably.
SCHEDULE 2
ESTIMATED BRANCH COSTS
(Annualized)

<table>
<thead>
<tr>
<th>EXPENSE ITEM</th>
<th>BRANCH COST</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent^52</td>
<td>$36,000</td>
</tr>
<tr>
<td>Personnel^53</td>
<td>$60,000</td>
</tr>
<tr>
<td>Overhead^54</td>
<td>$24,000</td>
</tr>
<tr>
<td>Total</td>
<td>$120,000</td>
</tr>
</tbody>
</table>

The average branch costs $300,000.\textsuperscript{55} Accepting that amount as a starting point, Schedule 2 estimates the occupancy cost of such a facility at 1\% of such amount per month (including up-fit and equipment). Schedule 2 assumes three full-time employees each earning $20,000 per year and 25\% overhead of combined occupancy and personnel costs. Based on those assumptions, the hypothetical branch requires annual revenue of $120,000 to cover its cost of operation. Taking the $11 profitability estimate for EFT '99 accounts,\textsuperscript{56} and doubling it to reflect expense consistently with Schedule 1, it would take over 5,400 accounts to cover the cost of the hypothetical branch. Using the gross margin figures from Schedule 1, excluding fees, it would take over 2,600 loans comparable to Loan 1 to cover such costs, 54 loans such as Loan 2, but only thirteen loans like Loan 3, to cover these costs. If one assumes that accounts and loans involving the poor and working poor tend to be small, it takes a substantial volume of activity for a branch to reach break-even status, much less earn a profit.\textsuperscript{57}

\textsuperscript{52} One percent of estimated cost of branch ($300,000) per month.
\textsuperscript{53} Three employees at a salary of $20,000 p.a. each.
\textsuperscript{54} Twenty-five percent of rent and personnel expense.
\textsuperscript{55} \textit{STEGMAN, supra} note 4, at 45.
\textsuperscript{56} \textit{Id.} at 103.
\textsuperscript{57} An interesting outcome of the research on the unbanked contained in \textit{Savings for the Poor} is that the likelihood of being unbanked “is not affected by whether one lives or works near a bank.” \textit{Id.} at 32 (citation omitted). The analysis goes on to point out that the extent of a neighborhood’s poverty has a positive correlation with
This conclusion is supported by my experience in practice. During my service as general counsel of a bank, my colleagues and I established an outreach program to the African-American community in a major North Carolina city. This arrangement was centered in an inner-city branch that was a marginal performer. Over time, the increase in activity through our outreach program raised the profitability of the branch to a positive basis, even considering EVA. This result took the better part of two years to achieve and involved a significant amount of management time and energy that had to be directed from other activities. We were proud of this effort and learned a great deal from it; however, on a pure economic basis, the effort expended did not bring a commensurate return.58

It was with this background and perspective that my colleagues and I considered EFT '99 when it was announced. Contrary to Mr. Hawke’s comment quoted above, we were not unaware of EFT '99; rather, we were trying to determine how to deal with it. Our concerns were similar to those attributed to bankers in Savings for the Poor. In our view, it was not likely that we could meet the requirements of EFT '99 through conventional, off-the-shelf products; accordingly, substantial development resources were going to have to be expended to participate. Further, we were concerned with the administrative requirements of the program, including the generation of the monthly paper statement from a cost perspective, particularly given the $3 per month maximum charge imposed by EFT '99.59 For doing this additional work, EFT '99 appeared to hold in prospect enough small accounts to be a burden, but not enough to make a profit. We were not indifferent or hostile to EFT '99; resigned is more like it. It did not appear likely to us that EFT '99 was going to

unbanked status; however, and accordingly, Professor Stegman interprets the evidence as “mixed.” Id. at 31.

58. See also Laura Mandaro, Union Bank, Check-Casher Team Up, AM. BANKER, Sept. 25, 2000, at 1 (discussing Union Bank’s attempt to serve low and moderate income communities by locating branches within the offices of check cashers). As the Union Bank executive responsible for this venture points out, “It’s adding services to a fully financed platform that’s the economic magic of this.” Id. at 6. The article points out that this venture has been criticized by community activists. Id.

59. STEGMAN, supra note 4, at 95-96.
generate book profit for our firm, much less positive EVA.

*Savings for the Poor* highlights firms that probably are generating positive EVA while serving the poor and working poor: the "nontraditional competitors." As noted above, these firms compete successfully because of convenience and knowledge of the market. Their financial returns are better because their cost structure is lower. They are, at least until recently, less regulated and charge substantially more than traditional institutions. The amount of such fees and charges has come under increasing criticism from advocates, legislators and regulators. Such criticism kept the non-traditional competitors out of the field with regard to EFT '99 and limited the amount that traditional competitors could charge for EFT '99 services. Given these limitations, Treasury's frustration with bankers is a little difficult to understand. In the absence of significant profit, firms organized to achieve profit will have little or no incentive to serve any market, low income or otherwise.

The foregoing response to *Savings for the Poor* is not intended either to blame the poor and working poor for their circumstances or to confer "victim" status on bankers. Whatever one might otherwise think of the CRA, it has had a profound educative effect on banking organizations about the needs of people not yet reached by the traditional financial system. Further, as public institutions, most banking organizations have a profound sense of responsibility for the communities they serve. However, banking organizations have obligations to employees, depositors and shareholders. These obligations cannot be fulfilled unless the institution operates at the most profitable level of which it is capable. If, in serving the poor and working poor, a bank cannot charge rates, fees and charges sufficient to create positive economic value added, from the perspective of the bank, CRA / community outreach becomes an unfunded mandate or charity. In either case, the amount of capital that the firm can commit to such activity in such circumstances is limited. *Savings for the Poor* chronicles a process where the stakeholders did not come to an optimum resolution of their differences, in substantial part because of a profound disagreement on what an appropriate level of profit was for the EFT '99 account. As a result, capital has not flowed
As noted above, Professor Stegman is undaunted by the outcome of the EFT '99 debate among the stakeholders. He showcases a number of successes fostered by the program and by efforts in a number of states to employ technology to serve the poor. His argument reflects an open mind about methods and delivery channels for financial services to the poor. *Savings for the Poor* is an invitation to further dialogue among the stakeholders with regard to this matter. I, for one, hope that the invitation is accepted and that all of the stakeholders engage in it with similarly open minds, particularly with regard for the role of economic incentives in obtaining an optimum result.

### III. BRIEF FOR A CHANGE IN PUBLIC POLICY

*Savings for the Poor* is not solely a book about banking. It is about altering public policy to address the persistent problem of poverty in the United States. At its best and most persuasive, it is a brief in favor of a change from an entitlement approach to one that focuses on empowering the poor and working poor to improve their circumstances by work and thrift. Professor Stegman reviews the history of public encouragement of asset accumulation from the Homestead Act forward, including the support of home ownership and savings through the Internal Revenue Code. He reviews a number of recent actions at the federal and state levels to increase the amount of property people on welfare can own and to remove disincentives to savings in existing welfare programs. A number of these proposals are bipartisan in nature, which is a hopeful sign indeed.

Along with EFT '99, the principal tool of Professor Stegman's proposal is the Individual Development Account (IDA). While the name of this account may vary, there are a number of common attributes of its various manifestations:

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60. Id. at 123-129.
A key feature of all IDAs is that every dollar saved by an individual is matched by a community group, foundation, church, or government. Another distinguishing feature of IDAs is that participation is conditional upon the saver’s completion of a financial education program. The final distinguishing characteristic of an IDA program is that withdrawals are limited to specific purposes . . . [generally] buying a house, getting an education, or starting a business.\textsuperscript{61}

Professor Stegman envisions a world where the poor and working poor enter the banking system through EFT ‘99, use their accounts as a vehicle for their initial saving, use such savings to open IDA accounts and develop the habit of saving and attendant increases in net worth as they move from dependency to self-sufficiency. This is a compelling vision that is supported by substantial research and by the ongoing activities of leading community development organizations.\textsuperscript{62}

The implementation of a coordinated program of the kind described in \textit{Savings for the Poor} is, of course, ultimately a political issue. Professor Stegman does not deny this, noting that one of his goals in writing this book is to convince the Administration and Congress to use EFT ‘99 as the vehicle for giving lower-income, low-wealth Americans “a chance to own a piece of the country.”\textsuperscript{63}

Funding for IDAs will come, either directly or indirectly, from the federal government and, accordingly, it is easy enough for banks and their counsel to ignore this issue and let the other stakeholders in the poverty debate fight it out. Given the need for financial intermediaries to be involved in the implementation of Professor Stegman’s ideas (EFT‘99 and IDAs) on a significant

\textsuperscript{61} \textit{Id.} at 130 (citation omitted).

\textsuperscript{62} Among such organizations is the Center for Community Self-Help in Durham, North Carolina, founded by Martin Eakes on the basis of his insight that the problem of poverty cannot be addressed effectively by focusing on income; rather, that the acquisition of wealth should be the focus of effort. This insight lead him and his organization to path-breaking activities to foster home ownership for low and moderate income people and to a MacArthur Foundation award for Eakes.

\textsuperscript{63} \textit{Id.} at 11.
scale, banks will be involved in the new policy regime, if adopted, whether they like it or not.\textsuperscript{64}

As noted above, \textit{Savings for the Poor} is an invitation to dialogue about moving from poverty policies that have not worked to others that may. Indirectly, banks have borne a share of the burden of the failed policies and have met the burden at significant expense. The new policies proposed by Professor Stegman may provide banks with the opportunity to do their share more efficiently and profitably. When and as the conversation continues, banks and their counsel would be well advised to participate. Reading this important book would be a good place to begin their preparation.

\textsuperscript{64} See \textit{Squeezing the Banks}, supra note 19, at 53 for an example of one potential outcome of such debate. The article reports on a proposal by the English Post Office to operate a "universal bank" for the poor and working poor with retail locations in post office buildings. \textit{Id.} The British Government has "suggested" that banks assist in funding this enterprise to the tune of £150 million to £200 million per year, with each bank's contribution between £30 million and £50 million per year. \textit{Id.}
BANKING THE UNBANKED: UNTAPPED MARKET OPPORTUNITIES FOR NORTH CAROLINA’S FINANCIAL INSTITUTIONS

MICHAEL A. STEGMAN

I. INTRODUCTION

In the new economy, it is as important to have access to a basic bank account and financial services as it is to have access to electricity, running water, and a telephone. This is why policymakers, bankers, and their counsel should be concerned that, despite the longest economic expansion on record and the lowest unemployment rates in a generation, 10% of all American families—including 25% of African-Americans and Hispanics, a quarter of all families with incomes under $20,000, and nearly half of all families moving from welfare to work—have no bank account. Assuming this same one-of-ten ratio also applies to North Carolina, more than 300,000 Tar Heel families are unbanked.

Doing a better job of bringing the unbanked into the financial mainstream is important because one’s banking status has profound implications for long-term family self-sufficiency. In 1998, for example, the median value of all assets held by unbanked families was just $2,300, compared with $136,000 for all banked families. Lack of savings is particularly important to low- and moderate-income families in general and to unbanked families in

1. I would like to acknowledge the invaluable research assistance of Kelly Cochran.


4. FED. RESERVE BD., supra note 3.
particular because they are much less likely than other households to be covered by a retirement plan at work. In 1998, more than nine out of ten (92%) unbanked families were without a retirement account, compared with less than half of banked families (47%). Indeed, for more than half of the unbanked (54%), their only asset is their car.

In my recent book, *Savings for the Poor*, I suggest how a cluster of new public policies—most importantly, the federal transition to electronic funds transfer (EFT) or the delivery of government benefits through direct deposit—present new opportunities for financial institutions to better serve unbanked and marginally-banked populations. Because of EFT, the Treasury Department has undertaken several initiatives to stimulate the development of new, low-cost banking products for unbanked federal benefit recipients. As part of this transition, Congress has also required all states to convert their food stamp programs to electronic payment by 2002, using point-of-sale (POS) terminals at participating retailers. And, while not required by law, more than forty states have decided to add their emergency cash assistance programs to the plastic food stamp cards so that welfare benefits will be accessible at ATM and POS networks.

Although the push to convert millions of benefit checks to electronic payments was begun to save the federal government money—as much as $100 million a year according to one estimate—in my book I argue that EFT is more than an exercise in cost-saving technology transfer. When viewed in the context of a larger policy framework that rewards work, personal responsibility, and encourages the working poor to save, EFT is about financial inclusion and the recognition that "economic opportunity cannot thrive where access is denied."

In his review of my book, Mr. Joseph Smith argues that while most banks have a profound sense of responsibility for the

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5. *Id.*
6. *Id.*
communities they serve, they cannot always fulfill their obligations because aggressively serving the poor and near poor "is incompatible with operating their institutions at the most profitable levels of which they are capable." While I agree that the economics of better serving marginalized populations are critical, there is strong evidence that significant market opportunities exist for "first-movers" and creative institutions that do not sit back to wait for policy makers to put government programs in place, but rather use technology and strategic alliances to bank the unbanked. Rather than focusing on many of the national policy initiatives discussed in Savings for the Poor, I prefer to use this opportunity to apply the arguments in my book specifically to North Carolina and start a conversation with the local banking community about the challenges and opportunities posed by EFT.

This Article is divided into five parts, beginning with a discussion of North Carolina financial services: the decline in the number of commercial banks and thrifts along with significant market concentration by a handful of institutions, the explosive growth in the number of "fringe banks"—most notably check cashing outlets and payday lenders, and the scale of their volume. Next, I link the national policies that are supporting new banking initiatives for the poor to North Carolina, providing, where possible, data and statistics that might be useful to bankers in their business formulations. Next, I summarize banking innovations that are useful models for North Carolina financial institutions to consider, emulate, or build upon. In the final section I reaffirm my call for certain refinements in the Community Reinvestment Act (CRA) with which Mr. Smith takes issue—hopefully explaining it more compellingly than I evidently was able to do in my book.

10. See infra notes 14-47 and accompanying text.
11. See infra notes 48-58 and accompanying text.
12. See infra notes 58-90 and accompanying text.
13. See infra notes 91-105 and accompanying text.
II. N.C. BANKING: FEWER INSTITUTIONS, MORE BRANCHES, AND GROWING MARKET SHARE

The interplay of the same factors—among them the deregulation of interest rate ceilings in the 1980s, new technology, and growing competition from nondepository institutions—that led to a significant decline in the number of federally insured financial institutions in the United States are causing similar results in North Carolina. The number of commercial banks in North Carolina declined by almost half (48%) since the mid-1960s, while in a much shorter period—from 1986 to 1999—the number of thrifts fell by two-thirds.

Also consistent with national trends, the total number of banking offices in North Carolina has doubled since the 1960s, increasing by forty in 1999 alone. This is partly the result of growth by established institutions and partly because North Carolina continues to be fertile ground for de novo banks. Thirty-five new banks were chartered in North Carolina during the 1990s,

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reportedly "tops in the nation". At least two of them—Greenville-based Millenia Community Bank and Pembroke-based Lumbee Guarantee Bank—are targeting under-served populations.

Nationally, most of the 29% increase in banking offices during the past twenty years has occurred in middle-income areas. In contrast, the number of branch facilities declined by 21% in low-income neighborhoods. Notwithstanding North Carolina’s modest increase in de novo community banks, the boom in the fringe banking industry discussed below suggests that there may have been a similar decline in mainstream banking services in low- and moderate-income communities in this state.

In the third quarter of 2000, the eight biggest NC-based banks—each with assets of more than $1 billion—held more than 98% of all deposits in the state. This is a significantly greater degree of market concentration than exists nationwide, where similarly sized banks hold 80% of total deposits. Though it ranks as the nation’s second biggest bank, Bank of America ranks only fifth in the size of its North Carolina branch network, but is first in market share, holding about 22% of all North Carolina-based deposits. BB&T, first in branches, is second in market share (15%) followed in order by Wachovia (13%), First Union (11%), and Centura (7%). Central Carolina Bank, which was recently acquired by National Commerce Bancorporation, controls about

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20. Catherine Pritchard, Small Banks a Perfect Fit, FAYETTEVILLE OBSERVER-TIMES, (Fayetteville, N.C.) May 31, 1998, at D1; Ed Martin, De Novo Banks: Small Cogs Help Turn a Big Economy, NORTH CAROLINA, 12

21. STEGMAN, supra note 7, at 2.


24. Id.

of the North Carolina market.\textsuperscript{26}

Several of the largest Tar Heel banks are leaders in the use of technology to develop alternative delivery channels - five are in the American Banker's top 50 Bank Holding Companies in ATM ownership,\textsuperscript{27} and a similar number have been judged to be among the nation's top 100 banks in web influence.\textsuperscript{28}

III. THE EXPLOSIVE GROWTH OF "FRINGE BANKS" IN NORTH CAROLINA

Though less understood, studied, or regulated, there is a parallel system of financial services providers that primarily serve lower-income working class communities in North Carolina and the nation. The core of this "fringe banking" industry, as it is commonly referred to by consumer advocates, is a national network of check cashing centers and payday lenders that cash more than 180 million checks a year with a face value of $55 billion.\textsuperscript{29} Not withstanding the fact that they are banned in 19

\begin{footnotesize}
\begin{enumerate}
\item[26.] Id.
\item[27.] Bank of America is first in the country with 14,082; First Union is fourth, with 3,689, Wachovia is eighteenth with 1,374, and BB&T is twenty-first with 900. \textit{Top 50 Bank Holding Companies in Automated Teller Machines}, AM. BANKER, Dec. 6, 1999, at 12A.
\item[29.] STEGMAN, supra note 7, at 63 (citing national statistics). Payday loans are small-dollar, high-interest, short-term loans backed by post-dated personal checks that borrowers promise to repay out of their next paycheck. Memorandum from Richard M. Riccobono, Deputy Director, Office of Thrift Supervision, Department of the Treasury, to Chief Executive Officers 1 (Nov. 7, 2000), \textit{available at} http://www.ots.gov/docs/25132.pdf (last visited Feb. 5, 2001). North Carolina law sets a ceiling of $300 on the amount that can be borrowed at any one time, limits fees to fifteen percent of the amount borrowed—which translates to a maximum of $45 on a $300 loan—and provides for a maximum term to maturity of thirty-one days. N.C. Gen. Stat. § 53-281 (2000); see generally N.C. Gen. Stat. §53 Art. 22 (2000) (relating to "Check-Cashing Businesses").

In practice, according to state regulators, the vast majority of all payday loans
states because of their high cost and potential for abuse,\textsuperscript{30} the number of payday lenders has grown from just a few hundred outlets in the mid-1990s to approximately 10,000 today.\textsuperscript{31} One investment banking firm "forecasts the market to expand to 25,000 stores by 2002, producing 180 million transactions, and $45 billion in loan volume that will generate $6.75 billion in fees annually."\textsuperscript{32}

As suggested above, North Carolina has become fertile ground for fringe bankers. Statewide, some 200 licensed check cashing companies operate more than 1,200 outlets.\textsuperscript{33} While not all check cashers in the state extend credit, at year-end 1999, some 136 companies with more than 1,000 offices engaged in payday lending, which translates to about ten percent of all payday-lending outlets in the country.\textsuperscript{34} In 1999, payday lenders in North Carolina originated more than 2.9 million transactions totaling more than $535 million, generating in excess of $80 million in fees.\textsuperscript{35} And these numbers are only part of the story of how non-bank financial companies are filling a critical credit void, since they exclude the 300 or so licensed pawnbrokers in North Carolina that provide their own unique brand of consumer credit.\textsuperscript{36}

One way of putting this booming financial services industry in perspective is to note that there is one check cashing outlet/payday lender in North Carolina for every two FDIC-insured banking offices.\textsuperscript{37} Five small counties have either the same

\begin{itemize}
\item \textsuperscript{30} Marcy Gordon, \textit{Senator Condemns 'Payday Loans'}, \textit{AP Online}, Dec. 16, 1999.
\item \textsuperscript{32} Id.
\item \textsuperscript{33} \textbf{OFFICE OF THE COMM'R OF BANKS, REPORT TO THE GENERAL ASSEMBLY ON PAYDAY LENDING 5} (2001), \textit{available at} www.banking.state.nc.us/pubcatns.htm (last update Feb. 22, 2001).
\item \textsuperscript{34} Meacham Interview, \textit{supra} note 29.
\item \textsuperscript{35} Id.
\item \textsuperscript{36} Id.
\item \textsuperscript{37} This figure and all of the following data on the number and location of check cashers and payday lenders in North Carolina are the results of the author's
number of banks as check cashers or more check cashers than banking offices. And three of the state's seven economic development districts—all in Eastern North Carolina—are significantly under-banked. These include the eleven-county Southeast economic development district, and the thirteen-county Global Transpark district, where the overall ratio of fringe banks to mainstream banks is .70 and .65, respectively. In addition, eight of the sixteen counties that comprise the Northeast economic development district are under-banked inasmuch as their respective individual ratios of fringe banks to conventional banks is greater than the statewide average of .50.40

Fringe banks are also expanding more rapidly than conventional banks. The number of banking offices increased by less than two percent in 1999 (a net increase of 40). In contrast, the number of fringe banking outlets increased by 73%, or by 520 offices between late 1998 and January 2001. While much of this growth has been in the poorer regions of the state—163% growth in the Western economic development district and 125% in the Northeast—wealthier districts like the Research Triangle saw a 71% increase in the number of check cashers and payday lenders, including 82% growth in Wake County. The Charlotte area also witnessed significant growth, with Mecklenburg County having forty-seven more fringe banking offices today than two years ago, bringing the grand total of fringe banks to 115 outlets in the heart

calculations from data obtained from the North Carolina Office of the Commissioner of Banks. Details are available from the author.

38. The five countries are Cumberland, Edgecombe, Hoke, Vance, and Washington Counties.


40. The under-banked counties in the Northeast are Beaufort, Chowan, Halifax, Hertford, Hyde, Martin, Perquimans, and Washington.

41. FDIC data are for 2000 at the time of this writing.


43. Id.
of North Carolina’s and the Southeast’s banking capital.44

While there has been no systematic analysis of where fringe banks locate relative to mainstream banks within communities, our own research in Charlotte is instructive.45 We found that check cashers and payday lenders are not scattered throughout the city, but are more likely to locate in high-minority and working class neighborhoods. Relative to population, there are one-third as many banking offices and more than four times as many check-cashing offices in high-minority neighborhoods as in low-minority neighborhoods.46 Because payday lenders target working families with bank accounts—you need a checking account in order to patronize a payday lender—they are most likely to locate in moderate-income neighborhoods rather than in the city’s poorest communities. Eighty-five percent of all check cashers in Charlotte (compared with fifty-five percent of all households) are in working class neighborhoods with median incomes between $20,000 and $40,000.47

IV. COMPLEMENTARY PUBLIC POLICIES

As I argue in my book, EFT and state-related EBT efforts create a substantial market opportunity for traditional financial institutions. North Carolina, for instance, ranks ninth among the fifty states in the number of paper benefit checks—more than 600,000 a month—that could be routed into electronic transfer and other bank accounts.48 In addition, more than 212,000 food stamp recipients have now been trained to use POS terminals to access their benefits, which has familiarized them with modern banking

44. CHECK CASHERS, supra note 39.
46. Id. We identified 3.8 banking offices and 6.7 check-cashing outlets per 10,000 households in Charlotte neighborhoods that are at least 70% African-American, compared with 12.5 banking offices and 1.6 check-cashing outlets per 10,000 households in neighborhoods that were less than 10% African-American. Id.
47. Id.
technology like debit cards.  

A number of recent policy initiatives that complement EFT promise to further enhance the economics of serving unbanked and under-banked populations. The most important of these involve savings initiatives for working families like those being piloted in Individual Development Account (IDA) programs across the country. IDA programs can make EFT and related banking initiatives not only more powerful forces for individual empowerment but can significantly improve the economics of low-cost account products for banks. While EFT has the potential to bring more people into the financial mainstream, savings incentives give them a reason to open an account and use their banked status to begin saving for their future.

Specifically, these policy initiatives include:

**Treasury's First Accounts Initiative.** After launching EFT'99, Treasury recognized that federal benefit recipients account for only about half of the 9.5 million American unbanked families, and that for the unbanked to become a commercially viable market, new accounts, marketing strategies, community-partnerships, and financial education campaigns must be targeted to all unbanked families and not just those who receive government checks. Congress appropriated $10 million this fiscal year to support pilot partnerships between financial services providers and community organizations to provide the unbanked with access to low-cost accounts, ATMs, other electronic banking products, and financial literacy education.

**Welfare Reform.** Although often overlooked, it was the watershed Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (PRWORA) that helped legitimize government's role in helping the poor build assets. The rationale for an asset-based social policy is that assets promote a longer planning horizon by the poor and a variety of positive attitudes and behaviors, including household stability, community

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involvement, and political participation. Welfare reform not only led to new rules that liberalized asset limits—North Carolina raised its limits from $1,000 to $3,000—but it also encouraged savings by promoting IDAs. IDAs combine budget and credit counseling with a program of matched savings that help the working poor invest in a home, education, or their own business. The welfare reform law permits states to use their welfare block grants to fund IDAs and account balances in eligibility determination for all means-tested federal benefits. A total of thirty-one states have enacted legislation to support IDAs, with most of this legislation occurring since 1995.

**Individual Development Accounts.** The most important thing that banks should know about IDAs is they are proving that, with appropriate support and incentives, poor people can save. Two-year results from the nation's largest national demonstration in fourteen sites found that participants with incomes at about 130% of poverty are saving an average of about 3% of their income, or $24 a month. The Assets for Independence Act (AFIA) enacted in October 1998 authorizes $125 million in federal funds to support local IDA programs over a five-year period. After appropriating $10 million a year for AFIA in FY 1999 and 2000, in response to local program successes, Congress appropriated $25 million for AFIA in FY 2001.

Unfortunately, Congress did not pass the proposed Savings for Working Families Act of 2000 in the last session, which would have authorized $5-$10 billion in federal tax credits for financial

51. Id. at 1.
52. Id. at 5.
institutions and private sector investors to set-up, match, and support IDAs at financial institutions. However, there continues to be strong bipartisan support for a national IDA program that would be funded on the tax side of the federal budget, and renewed efforts to pass SWFA will likely be made in the 107th Congress.

There are presently seventeen operational IDA programs in North Carolina that are being supported with funding from the North Carolina Departments of Commerce and Labor, and from local support from the City of Durham. Early program data from North Carolina are consistent with national findings. One national study of eleven IDA programs, including those in North Carolina, showed that average account balances per participant were $903, including both deposits and accrued match, ranging from a high in $2,361 in Raleigh to a low of $362 in Chicago.

V. INNOVATIVE PRODUCTS FOR THE UNBANKED

In the course of our research, we have identified many products that target the unbanked, several of which I summarize here in hopes that they will stimulate creative thinking among North Carolina financial institutions. Some of these products are built around technology, others use off-the-shelf products that are delivered through community development partnerships. Others blend the products and services of fringe- and conventional-banks to help transition unbanked customers into the financial mainstream, while still others use payroll direct deposit to attract new low- and moderate-income customers at the work-place, many of whom are unbanked.

57. STEPHANIE A. JENNINGS, ELIZABETH KEHBERGER, ROBERTO G. QUERCIA, WILLIAM M. ROHE, AND MICHAEL A. STEGMAN, HELPING FAMILIES BUILD ASSETS: THE IMPLEMENTATION OF INDIVIDUAL DEVELOPMENT ACCOUNTS IN NORTH CAROLINA 1 (May 1999) (prepared for the North Carolina Working Group on IDAs and Asset Building and can be ordered from the UNC Chapel Hill, Center for Urban and Regional Studies). The North Carolina General Assembly and the North Carolina Department of Commerce have allocated $860,000 for IDAs. Id.
58. MILLS ET AL., supra note 50, at 63.
A. Technology-Based Products

1. Banco Popular’s Electronic Transfer Account (ETA).

The transition to direct deposit of federal benefits is much slower than the government had hoped. In the first year, only about 5,000 people have opened a low-cost, government-designed Electronic Transfer Account (ETA) that the Treasury designed to take direct deposits from Uncle Sam. However, one particular bank has distinguished itself as a model provider.9

As of October 31, 2000, the $18.4 billion asset of Popular Inc., Banco Popular de Puerto Rico, had opened more than 3,000 ETA accounts.60 This is more than sixty percent of all ETAs opened by all U.S. banks, but number two on the list, Firstar Bank of Milwaukee, has opened just 405 ETA accounts.61 Banco Popular attributes its success to three facts: (1) serving the unbanked is a long and honored tradition of the People’s Bank of Puerto Rico—its 2001 business plan calls for converting an additional 35,000 unbanked individuals; (2) it uses its most sophisticated technology and delivery systems to create low-cost, and low-risk accounts for financially marginalized populations, including debit cards without checking privileges to prevent overdrafts; and (3) despite low account service charges—ETA charges are limited by the Treasury to $3 a month—Banco Popular invested more than $100,000 in a rollout campaign and provided financial incentives to employees for every ETA account they opened during the early months of the campaign.62

In response to a recent Treasury inquiry of how banks could better serve unbanked persons who do not receive government checks, Banco Popular indicated an intent to create a

61. Id.
low-cost electronic combined account that would contain separate transaction and savings purses. Like the ETA, to simplify account management, reduce risk, and avoid overdrafts, no check writing or off-line transactions would be available for this account. This account, which would work best if combined with payroll direct deposit, would feature a savings plan option involving an automatic transfer of a pre-specified amount of money each pay period from the transaction-to the savings-purse. Customers would have electronic access to the transaction purse through ATM and POS terminals, but to discourage savings withdrawals on impulse, there would be no electronic access to the savings purse—all withdrawals would have to be made in person at a bank branch. A savings bonus would encourage balances of long duration.


According to an analyst at McKinsey and Company, Standard Bank of South Africa is defying “the conventional wisdom of the financial-services industry: that the low-income market is at best marginal, at worst disastrous.” The bank created its E-Bank (later renamed E-Plan) program in the 1990s to serve a growing market of low-income, largely illiterate wage earners who could no longer receive their pay in cash because of growing crime problems. When employers switched to paying employees by check or direct deposits, Standard Bank was flooded by waves of unbanked customers. Operating exclusively through a “fingerprint-secured” debit card system and ATM network that is programmed to give operating instructions in each of South Africa’s eleven official languages, costs per outlet are 30% to 40% below those of traditional branches. ATM technology greatly reduces the delivery and service expenses of transactions and sales (since there is no back office) and the bank minimizes unit cost of

63. See id.
65. See id. at 128.
66. Id. at 127.
67. Id. at 129.
its ATMs by using education and incentives to maintain high transaction volume. E-Plan grew to around 340,000 accounts by 1996. By 1999, the number of E-Plan accounts had grown to 2.6 million, with around 50,000-60,000 new accounts opened each month.


For several years now, the U.S. Department of Housing and Urban Development has supported the development of computer learning centers in assisted housing developments. To my knowledge, few of these “neighborhood networks” are being used to help connect residents with banking services. A new Internet-only bank recently announced that it would partner with a large housing developer to target residents of such housing, most of whom are working and trying to improve their financial standing and credit record.

Umbrellabank.com of Westmont Ill., which opened [in June 2000], is working with the Chicago Equity Fund to install automated teller machines and personal computers in assisted housing in the Chicago area. The bank will also provide representatives to teach residents how to use the machines and to foster financial planning and the use of checking, savings, and credit accounts. The new bank, a subsidiary of the $391 million-asset Argo Bancorp, . . . will have access to Argo’s network of 1,000 ATMs throughout the Midwest and East Coast, [and] plans to install additional ATMs in many of the buildings sponsored by the Chicago Equity Fund.

68. Id. at 129-130.
69. Id. at 127.
70. Megan J. Ptacek, Web Bank Plans ATMs for Subsidized Housing, AM. BANKER, June 20, 2000, at 12.
71. Id.
B. Community Development Banking Partnerships

1. Chicago CRA Coalition and Bank One's Alternative Banking Program (ABP).

"The Coalition, which is convened by the Woodstock Institute ... developed an agreement with Bank One when it purchased First Chicago Bank NBD in 1998," that included a pilot program "to promote deposit services to unbanked customers."72 Rather than a separate product, "the Alternative Banking Program (APB) incorporates into standard Bank One products features similar to a model lifeline account, including: $10 to open an account, minimum balance as low as $0 ... unlimited check writing, unlimited use of Bank One ATMs, and some free teller transactions, depending on the account."73

Bank One [also] conducts financial literacy workshops in cooperation with community partners to demonstrate cost savings over check cashers, improve financial management skills, and increase trust ... with mainstream financial institutions. Although applicants with a credit history must have suitable credit scores, people with no or borderline credit may also open accounts. In exchange for more flexible credit criteria, the bank established some modest restrictions on the ABP. However, after one year, account holders can apply to upgrade to traditional account[s].74

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73. Id. at 5. The two other features of the APB are: a service fee as low as zero dollars depending on the account and free financial literacy training. Id.
74. Id. at 5, 17.
2. The Extra Credit Savings Program.

The nation's preeminent for-profit community development bank, South Shore Bank (SSB), and the Center for Law and Human Services created the Extra Credit Savings Program to encourage the unbanked working poor to save a portion of their sizable Earned Income Tax Credit (EITC) refunds by providing them with low-cost savings accounts. Between January and April 2000, the Tax Counseling Project of CLHS offered free tax preparation assistance to EITC-eligible individuals two nights a week at a SSB branch. On these evenings, SSB bankers invited individuals to join the ECSP. Those who chose to participate opened a no-fee, no minimum balance savings accounts and arranged to have their 1999 federal tax refunds directly deposited into the accounts. Funds in these accounts earn a market rate of interest (currently 2.5%), and a no-fee ATM card is available. As an extra saving incentive, participants receive an additional 10% bonus on any funds remaining in the account on December 31, 2000 (up to a maximum bonus of $100 per account-holder).

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76. The Earned Income Tax Credit is a refundable federal tax credit designed to help low-income workers increase their financial stability. "In 1998, the EITC was expected to cost the federal government $30.5 billion according to the Council of Economic Advisors. More than 19.7 million working families benefited from the EITC in 1998." Timothy M. Smeeding, The EITC and USAs/IDAs: Maybe a Marriage Made in Heaven? 2 (Nov. 2, 2000) (paper prepared for the Annual Conference of the Association for Public Policy Analysis and Management (APPAM) Seattle, Washington, on file with author). "By 1999 a maximum refundable tax credit of $3,816 was available to low income households with two children and earned income between $9,540 and $12,460." Id. at 3.

77. Beverly et al., supra note 75, at 5.
C. Transitions to Mainstream Banking

1. Union Bank of California’s Cash & Save Program

Union Bank’s Cash & Save is a hybrid program that goes beyond check cashing by using education and consulting services to transition previous check-casher users to traditional banking services. 78 “[W]ith profit margins ranging from fourteen percent to fifty-one percent at its fifteen locations, Cash & Save [successfully] competes with other check cashing outlets.”79 “But what differentiates it is the way it tries to bring unbanked customers into the financial mainstream rather than simply exploiting profit from their financial alienation.”80

Cash & Save provides a full range of services targeted to lower-income, ethnic markets with large contingents of unbanked workers. While each location provides basic check cashing services—at lower fees than those generally charged by [check cashers]—what really distinguishes Cash & Save from other check cashing operations is the range of banking services that it provides. Under its Money Order Plan, which carries a one-time fee of $10, customers get six free money orders per month plus a 1% check cashing charge. With Nest Egg Savings, a customer can open a no-fee, passbook interest rate savings account with an initial deposit of $10 and a commitment to deposit $25 monthly for at least one year. Cash & Save also offers a basic checking account for ... as little as one dollar, a secured credit card for people who are repairing their credit rating, and a direct deposit option for the electronic

78. STEGMAN, supra note 7, at 79. 79. Id. (citing Cynthia A. Glassman, Consumer Finance: The Borrowing/Savings Dilemma, J. of Retail Banking Services, Autumn 1996, at 54). 80. Id.
Almost one third of Cash & Save customers converted to traditional banking services in 1997, up from 14% in 1996.  

2. Arvest Bank's Credit Builder CD Loan

Because many of the entry-level employees of local poultry-processing plants were Mexican workers with no credit histories, Arvest Bank created the $1,000 Credit Builder CD Loan—a creative, low-cost way for consumers to develop a credit history while minimizing risk to the bank. Customers take out a $1,000 loan and deposit the proceeds in a CD. They then pay the loan back from monthly earnings to build a credit history and use the CD interest to help offset their loan interest payments. By repeating this process twice, borrowers gain confidence in the bank and in their ability to save regularly and build good credit. At maturity, the borrower has also accumulated $2,000 towards the down payment and closing costs on a modest house. Since 1990, the Credit Builder CD Loan program has led to more than 500 mortgage loans to immigrant families—with no defaults as of June 2000.

In the process, Arvest also experienced tremendous customer growth among the community's Latino workers—less than 8% of them had any previous banking relationship. "[W]ithin two years of the launch of this program over 60% of workers at participating plants" were Arvest customers, with 7% having purchased houses with Arvest mortgage loans, and 27% having had consumer loans. As of April 30, 1999, the bank's Latino

81. Id. at 80.
84. Id.
85. Id. at 19.
customers represented "a total of $26.5 million in business, including $5 million in deposit accounts, $1.2 million in consumer loans, $20 million in mortgage loans, and $341,000 in commercial loans."86

D. **Bank at Work Programs**

Bank at Work programs produce win-win partnerships between employers and financial institutions because of the savings each realizes when payroll checks are switched to direct deposit.87 Citibank operates one prominent Bank at Work program. With direct deposit of an employee’s pay, the bank offers a special checking account, special credit card offers, and discounted points on some credit products. “In addition, the employee is provided access to Citicorp Investment Services, no-fee PC Banking Service, no-fee Bill Payment service, and no-fee ATM transactions.”88 Currently, 43,479 customers in the bank’s assessment areas use the service.89 Two percent of the households participating in this program live in Low- and Moderate-Income census tracts.90

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86. Id.
87. Research by the National Automated Clearing House Association (NACHA) found that businesses could save more than $1.25 on each payroll check processed by switching to direct deposit. Banks save an estimated $0.70 for each check deposited through the ACH network instead of through the teller window where as many as 10 sets of hands touch each paper deposit. Additional savings from reduced fraud are also likely by using the ACH network instead of paper checks. Sam Frumkin & Karen Furst, *Direct Deposit: Using Technology to Reach the Underserved*, COMMUNITY DEVS., (Office of the Comptroller of the Currency, Washington, D.C.), Fall 2000 at 3, available at http://www.occ.treas.gov/cdd/resource.htm (last visited Feb. 5, 2001).
89. Id.
90. Id.
VI. CONCLUSIONS AND RECOMMENDATIONS

The fact that ten percent of the nation’s payday lenders and check cashers have located in North Carolina in the last two years should set off alarm bells in boardrooms across this state. These businesses are acting rationally in the face of a difficult market and are making the economics of serving low- and moderate-income households work for their owners and shareholders. Where traditional deposit accounts have proved unpopular with customers or unprofitable for banks, they have succeeded by selling money orders and check cashing services separately. Moreover, by tailoring products to meet customer demand and by providing convenient hours, locations, and other services, they are converting banks’ and thrifts’ own relatively low-profit checking account customers into high-profit short-term borrowers.

Some mainstream institutions are waking up to the size of the potential market. For instance, the State Employees Credit Union (SECU) recently introduced a lower-cost payday loan product after a statewide sample of its branches found that 4,000 members had written checks to payday lenders.91 SECU’s Salary Advance Option (SAO) is a reusable line of credit with a maximum loan of $500, at an interest rate of 11.75%; automatic transfer pays the balance of the loan after the direct deposit arrives on the next payday.92 SAO appears to be a highly competitive alternative to payday loans, which are capped at $300 under North Carolina law and are typically charged a fifteen percent fee.93 And while only eight small North Carolina banks initially signed up to offer ETAs to the recipients of more than 600,000 monthly federal benefit checks, Bank of America has announced a three-state pilot program, including North Carolina, through which, it expects to sign up 50,000 accountholders when the campaign is fully rolled out.94 Check recipients will get account applications while they

92. Id.
93. Id.
94. Id.
wait in line to cash their checks and will be able to apply over the phone.95

Other institutions are focusing on the same market that proved so successful for Arvest Bank. The 1997 Census estimates North Carolina’s Hispanic population to be about 150,000, which is almost double what it was in 1990.96 According to one estimate, North Carolina ranks among the top ten states in terms of the rate of growth of Hispanic buying power, which is forecast to grow by 255% between 1990 and 2001.97 To serve this burgeoning market, Cooperativa Communitaria Latina de Credito—North Carolina’s first Latino-focused financial institution recently opened for business in downtown Durham. Outperforming its business plan that set a modest goal of 500 members within the first year, the credit union had more than 1,100 members after just seven months.98 The credit union has begun offering an international money transfer service that costs just $6.50 to send up to $5,000 to

95. Daigle, supra note 59.
96. James H. Johnson, Jr., et al., A Profile of Hispanic Newcomers to North Carolina, 65 Popular Gov’t 2, 3, (1999). Most of this growth is in five counties—all of which are included in the top thirty U.S. counties with the most rapid growth in their respective Hispanic populations—Wake, Mecklenburg, Forsyth, Guilford, and Durham (ranked in declining order of their relative growth). Id.
97. Jeffrey M. Humphreys, Buying Power at the Beginning of a New Century: Projections for 2000 and 2001, 60 Ga. Bus. & Econ. Conditions 1,9,17 (2000). This compares with eight-six percent and three percent growth in buying power among white and African American consumers, respectively. Id. at 15. A combination of rising numbers, increasing incomes and a demographic profile that favors high marginal rates of consumption—seventy-seven percent of North Carolina’s Hispanic population is age thirty-five or younger, compared to fifty-two percent of the total population—suggests that rising Hispanic buying power will not only “energize” consumer markets for some years to come, including financial services. Johnson, supra note, at 3. H. Nolo Martinez, director of Hispanic/Latino Affairs for the State of North Carolina puts it this way:

In the area of economic development, we’re looking at what people need in order to understand financial institutions and practices, not only banks and banking but also savings and investments, like buying a home. You know, the American dream isn’t necessarily a realistic dream for these new immigrants because without formal credit you can’t buy a home.

El Salvador and Guatemala and is negotiating a contract with the Mexican Government that would carry the low charge of $8 for up to $1,000 transfer, which would also pay the official exchange rate for dollars to Mexican pesos on the day of the transaction. This is a better deal than is offered by more substantial companies and has a large prospective market. Nationwide, "immigrant workers sent $17.4 billion to their home countries last year, nearly double the level in 1991." Other market opportunities are as yet unrealized. Because of North Carolina's large working poor population, the federal EITC brings in as much as $1 billion per year to the state, suggesting that an effort to replicate the South Shore Bank savings model discussed in Part IV may have good local potential. And though state officials decided not to add cash assistance to the electronic food stamp cards, they are considering a campaign to encourage banked welfare recipients to sign up for direct deposit, and to make financial education a priority of welfare reform. The State Department of Social Services has also contracted with the Center for Community Capitalism to conduct a statewide survey of the financial services needs and behavior of welfare recipients and the working poor. In addition to informing policy makers and social services program directors, the results of this survey, which should be completed in Spring 2001, should contain useful market information for the banking community.

While Mr. Smith may be right to suggest that some banks and thrifts cannot profitably serve unbanked and marginally banked customers by expanding traditional branching networks or by offering Treasury's ETAs, North Carolina institutions can draw on extensive resources in fashioning other innovative programs like those highlighted in Savings for the Poor and Part IV of this

100. Competition Heats Up for Overseas Wire Transfers, News & Observer (Raleigh, N.C.) Nov. 23, 2000, at 3D.
article. Moreover, in addition to the state’s extensive network of branches and ATMs, banks have a wide range of potential community partners who can help deliver financial services in new ways. Specifically, North Carolina has more minority, community-based credit unions than any other state; the North Carolina Association of Community Development Corporations has more than 50 members; and with continuing appropriations from the General Assembly, the North Carolina Community Development Initiative is supporting a network of high-performing community development organizations. This network is ready and willing to work with banks, thrifts, and credit unions to improve financial literacy and to link working households to mainstream banking services.

If the economics alone are not enough to convince North Carolina banks to reach out to unbanked and marginally banked populations, I advocate refining the CRA to provide additional incentives for institutions that are examined under “large bank” procedures. Specifically, my proposal calls for increasing the importance of the service test—which focuses on retail banking and community development services such as financial education and IDA sponsorship—to account for more than its current weight of twenty-five percent of banks’ overall CRA ratings. This would enable a bank that is having difficulty in, say, the community development investment area—which is not a core business—to improve its overall CRA score by doing more to deliver financial services in low- and moderate-income communities—which is a core business. The fact that many banks are finding it hard to do well under the investment test has been confirmed by FDIC chairman Donna Tanoue and our own research.

We recently analyzed all “large bank” examinations of


103. The large bank exam has three components. The lending test counts for half a bank’s total score and the investment and service tests each count for twenty-five percent.

North Carolina banks since the current regulations went into effect in 1997, as well as the examinations for the fifty biggest banks in the country. Only five of thirty-two North Carolina examinations resulted in outstanding CRA ratings. More than half of the North Carolina tests scored in the middle-to-low range for "satisfactory," with three earning CRA scores that were just one point above a "needs to improve" rating. This is a sharp contrast to the distribution of CRA scores among the fifty biggest banks, where only about 25% of the tests scored in the low part of the "satisfactory" range.

When the scores are disaggregated by lending, investment, and service test, it is clear that North Carolina banks' poor performance on the investment test is dragging down their overall CRA scores. Of the thirty-two NC banks, ten received a "Needs to Improve" on the investment test, while another sixteen received scores of "Low Satisfactory." We found a relationship between bank size—measured by assets—and investment test scores. About half (four of nine) the NC sample with more than $1 billion in assets received High Satisfactory or Outstanding investment test scores. In contrast, only 9% (two of twenty-three) of smaller banks received better than Low Satisfactory.

North Carolina banks also performed worse than the "Top 50" sample on the lending test. The one bright spot for the state was the service test, where similar percentages or North Carolina (80%) and top fifty (78%) financial institutions earned either High Satisfactory or Outstanding ratings. Thus, increasing the weight of the service test could help many North Carolina banks improve their CRA scores while doing more to achieve financial inclusion.

105. Consult the author for more information about this work in progress at the Center for Community Capitalism at the University of North Carolina at Chapel Hill.