HOUSEHOLD AND COMMUNITY FINANCIAL STABILITY: Essential and Interconnected

Jennifer Tescher
Center for Financial Services Innovation

Financial services are the plumbing of our financial lives. They are the critical infrastructure that enable and support financial stability. Consumer finance practitioners often speak of the "pipes" or "rails" that move money, extend credit, and keep savings and investments safe. Just as communities struggle without access to credit for homeowners and small businesses, consumers struggle to save and build assets without institutional mechanisms.[1]

1 For a discussion about the constructs thought to be important aspects of institutions designed to promote saving and asset accumulation, see Michael S. Barr and Michael W. Sherraden, "Institutions and Inclusion in Saving Policy." In Building Assets, Building Wealth; Creating Wealth In Low-Income Communities, edited by N. Retsinas and E. Belsky (Washington, DC: Brookings Institution Press, 2005).

An estimated 30 million American households—one out of every four—lack this plumbing.[2] They lack access to the kinds of high-quality financial products and services that enable them to save, build assets, and achieve financial prosperity. Roughly one-third of these households are unbanked, meaning they have no checking or savings account with a bank or credit union. The remaining two-thirds are underbanked. They may have an account, but they are not using it to its fullest, and instead rely on a broad array of money-service businesses to meet their short-term needs.

Further, an estimated 42 percent of financially underserved households also face challenges in accessing traditional forms of credit because they have insufficient credit history.[3] Access to credit overall has become more limited since the Great Recession. As of 2010, an estimated 52 percent of the U.S. population had a FICO score below 600, representing a shift of 16 million people from "average" to damaged credit in just four years.[4]

Although unbanked and underbanked consumers are a large group representing a variety of behavioral and attitudinal segments, they are more likely to have lower incomes, be ethnic minorities, and have less education.[5] Yet this is not just a problem of the poor. The financial crisis and resulting foreclosure, unemployment, and financial deleveraging have exacerbated financial dislocation, affecting a wide range of households whose incomes masked weak balance sheets.[6] For instance, a recent study showed that nearly one-half of the households surveyed

---

2 Federal Deposit Insurance Corporation, "National Survey of Unbanked and Underbanked Households" (Washington, DC: FDIC, December 2009).

3 Center for Financial Services Innovation, "CFSI Underbanked Consumer Study" (Chicago: CFSI, June 2008).

4 KPMG, "Serving the Underserved Market" (New York: KPMG, 2011).

5 FDIC, "National Survey."

6 My thinking has been heavily influenced by the Household Financial Stability Project, a new effort led by Ray Boshara, senior advisor at the Federal Reserve Bank of St. Louis, to better understand and improve household balance sheets.

could not come up with $2,000 in 30 days, including 25 percent of the households earning $100,000 to $150,000 a year.[7]

Although financial exclusion and the resulting financial fragility appear to be an increasingly broad-based problem, it is a plight that continues to fall most heavily on lower-income and minority families with children. They are more at risk financially because they disproportionally lack steady income, savings and assets, and financial capability. Moreover, they are more likely to live in communities that offer less access to high-quality financial products and providers.

Participating in the financial mainstream and having the information and tools to manage money effectively in the short-term is a prerequisite for longer term saving and asset-building. Financially healthy households in turn yield healthy communities and vibrant economies. Consumers who rely primarily on cash spend extra time and money conducting basic financial transactions, creating friction and inefficiencies. Without appropriate incentives to encourage savings and a safe place to store funds, consumers lack a financial cushion to weather crises. Lack of access to formal financial networks also makes it more difficult to build a strong credit history, increasing the cost of credit and, for some, putting it out of reach entirely.

Despite the importance of financial services to household and community stability, basic financial products are often designed, marketed, and delivered in ways that fail to meet the needs, interests, and abilities of average consumers. They have requirements and minimums that are out of reach for those with lower incomes. They lack transparent pricing and terms and are increasingly complicated to use and understand. They often fail to provide consumers living paycheck to paycheck with immediate and convenient access to their money. They are marketed with poorly tailored messages and sold in locations that are intimidating, with operating hours that are inconvenient for

7 Annamaria Lusardi, Daniel Schneider, and Peter Tufano, "Financially Fragile Households: Evidence and Implications." Working paper no. 17072 (Cambridge, MA: National Bureau of Economic Research, May 2011).

many working families. They are underwritten with tools that cannot properly evaluate consumers with thin or nonexistent credit histories. Small mistakes can have enormous consequences, with consumers being shut out the system completely.

FINANCIAL SERVICES AS A COMMUNITY DEVELOPMENT IMPERATIVE

The emergence of the individual development account (IDA) is often credited as the moment when the community development field widened its focus beyond "place" to "people" by demonstrating the importance of individual assets in alleviating poverty. IDAs also had a different, unintended consequence: They demonstrated the importance of financial services in the asset-building equation. Research by Michael Sherraden, the grandfather of the IDA movement, showed the importance of formal financial mechanisms in facilitating savings. Simultaneously, grassroots efforts showed just how difficult it could be for some consumers to qualify for, open, and manage a basic bank account. Local nonprofit organizations had experience working with local banks on mortgage and small business lending; IDAs led them to the other side of the bank's balance sheet. The hundreds of grassroots organizations around the country that went on to launch IDA programs found themselves negotiating with local banks over the structure and price of bank accounts and learning about the systems and processes banks use to open and manage those accounts. Through financial education and one-on-one counseling with clients, they also learned just how financially fragile many were.

As IDAs were gaining in popularity in the mid-1990s, the federal government stumbled on the problem of the unbanked when it sought to deliver all federal benefits through direct deposit, only to discover that millions of benefit recipients had no account. To develop a strategy for dealing with this problem, the U.S. Treasury Department commissioned research that led to a better understanding of why people did not have bank accounts. Despite this increased recognition of the unbanked, the

Treasury's ultimate solution, the Electronic Transfer Account, did little to move significant numbers of benefit recipients to direct deposit. But because of the importance of basic bank accounts to the IDA model, a broader constituency became interested in the problem.

At the same time, the nonbank financial services sector was growing rapidly. For example, the number of payday lending stores grew from a few hundred outlets in the mid-1990s to more than 10,000 by 2000. The number of pawnshops increased from about 4,800 in 1986 to more than 11,600 in 2003.[8] Check-cashing outlets proliferated. This shadow banking system demonstrated that lower-income consumers had pent-up demand for financial services, and that they had money to spend. Unfortunately, it also became clear that predatory providers were stripping wealth from consumers and communities.

The 2000 and 2010 U.S. Census showed significant growth in the size of the Latino population, helping banks and credit unions recognize unbanked consumers as an untapped opportunity. The Latino population has more than doubled since 1990 and now totals 50.5 million, or 16 percent of the U.S. population, and as many as 43 percent are financially underserved.[9] These changes, coupled with the fact that nonbank providers were serving the market profitably, caused banks to focus more attention and resources on Latinos and other minority communities. A few banks and credit unions sought to leverage the growing distribution channel offered by alternative players by buying nonbank companies, partnering with them, or adding alternative products to their traditional product lines. Numerous banks began accepting government identification from Mexico and other Latin American countries in order to authenticate new customers, while the largest banks rolled out new remittance products. Underlying all these trends was the technology boom, which continues unabated today.

---

8 Annie E. Casey Foundation, "Double Jeopardy: AdvoCacey Explores The High Cost of Being Poor" (Baltimore, MD: AECF, 2005).

9 FDIC, "National Survey."

THE TECHNOLOGY REVOLUTION: OPPORTUNITIES AND ISSUES

It is difficult to overstate the changes and opportunities wrought by the technology revolution in financial services of the last 15 years. Technology-led innovation has yielded new products, marketing methods, underwriting mechanisms, and communication tools. The expansion of automated teller machines, the introduction of debit cards and point-of-sale terminals, and the emergence of online banking all offer new access points and reduced delivery costs that hold promise for reaching lower-income consumers. Technology can eliminate the barriers of time and distance, enabling people to move their money anytime, anywhere.

As the pace of development in financial technology has increased, so too has access to technology among the underserved. In 2000, a Pew Research Center survey found that 30 percent of adults with annual household incomes under $30,000 reported going online to access the internet or send email. By 2012, this number had more than doubled.[10] But the real story is the penetration of mobile phones, and in particular smartphones, which are becoming the device of choice for online access for the underserved and people of color. Today, nearly 90 percent of Americans own a mobile phone; 78 percent of financially underserved consumers have one. In 2012, smartphone users outnumbered users of more basic mobile phones. As a part of the overall trend, 38 percent of the underserved now own smartphones, compared to nearly 45 percent for Americans as a whole. Among African Americans and Hispanics, smartphone ownership rates are slightly higher than for the general population.[11]

---

10 Pew Internet and American Life Project, "Tracking Survey," available at http://pewinternet.org/Shared-Content/Data-Sets/2000/March-2000-Survey-Data.aspx (March 2000). Also see, Pew Internet and American Life Project, "Demographics of Internet Users," available at http://pewinternet.org/Static-Pages/Trend-Data/Whos-Online.aspx.

11 Board of Governors of the Federal Reserve System, "Consumers and Mobile Financial Services" (Washington, DC: Board of Governors of the Federal Reserve System, March 2012).

Financial services providers are capitalizing on the trend, with traditional depositories and their nonbank competitors introducing a bevy of mobile banking interfaces and payment platforms that can be accessed on all types of phones. While mobile financial services are designed to appeal to consumers across the income spectrum, the channel has considerable potential to provide services to underserved and lower-income consumers to encourage saving, debt reduction, and improved financial decision-making.

Technology also has expanded the playing field beyond banks and credit unions. Retailers, technology companies, and others have entered the market with new and innovative business models aimed at the underbanked market, thus increasing competition. Companies once considered financial services vendors, providing products for banks to use, are now marketing their products directly to consumers or using other nonbank firms, such as retailers or employers, to market them. More nonprofit organizations are exploring links between the services they provide and the financial health and capability of their clients, and some are beginning to form product marketing and distribution partnerships with financial providers. In addition, a new category of technology "enablers" has emerged, providing enhanced platforms for reaching consumers and moving funds. Companies like Google, PayPal, and Facebook are moving into financial services, largely as payment facilitators, but with the potential for far broader roles. There is also tremendous energy among financial technology entrepreneurs to combine mobile technology and social media to tap into the "power of the crowd" to provide peer support and incentives and make money management fun.

Banks are adopting many of these same technologies, but their ability and willingness to reach and serve financially underserved consumers, at least directly, remains in question. Although the technology by itself can reduce transaction costs, banks are piling that technology onto legacy systems and branch networks that are expensive and inefficient, resulting in costs-to-serve that far exceed the likely revenue they can generate in the short term from lower-income customers. Moreover, underserved consumers are not well understood by most banks and are often assumed to be "subprime," which has become a dirty word in the wake of the mortgage meltdown.

The emergence of new providers and distribution channels does not mean that banks and credit unions are no longer important partners. At a minimum, their "plumbing" is critical. One positive scenario would be for more banks to manufacture products for underserved consumers that can be distributed by other businesses and organizations, serving as the "back end" and letting someone else be the front door.

The question is what role banks should play in these relationships. Technology is shifting financial services from an institution-centric model to a customer-centric model. Do consumers need a financial "hub" to knit together the various products and services into a coherent quilt? Banks have always been the intermediary, and they still will be for many consumers. Today, however, many others are vying for the role. Understanding what models work best for linking basic transactions with high-quality saving and borrowing opportunities will be critical to effectively answering this question.

THE SEARCH FOR QUALITY

The most important question may not be *who* is best positioned to serve the underserved, but *what* products are they selling, and are they any good? The financial crisis was a crisis of quality. While some categories of providers behaved better than others, financial services providers of all kinds behaved badly. They sold harmful products in deceptive ways to unqualified borrowers, in many cases pushing households and communities off a financial cliff.

We now have an access problem, especially for credit, but we still are not clear about what high-quality financial products and services look like. Financial services providers are largely waiting for guidance from their regulators, fearful that any misstep will be seized on by both the media and consumer advocates. Regulators do not have a unified definition of high-quality financial products, and the Consumer Financial Protection Bureau, which has the greatest responsibility for figuring out the answer, will need to move more slowly and piecemeal than is ideal given its nascence and the nature of the rule-writing process. Consumer advocates are clear on the specific practices they think are harmful, but they generally lack a holistic perspective on what would be both beneficial for consumers and financially sustainable for providers.

Frustrated by this state of affairs and determined to continue moving the market forward, my organization, the Center for Financial Services Innovation, published a framing document in 2012 describing our vision of quality financial services and articulating a set of Compass Principles to guide product design and delivery: embrace inclusion to responsibly expand access; build trust to develop mutually beneficial products that deliver clear and consistent value; promote success to drive positive consumer behavior through smart design and communication; and create opportunity to provide options for upward mobility.

The principles are grounded in a broader view of how to make markets work. Financial services offerings must be profitable and scalable from a business standpoint if they are to offer lasting solutions for consumers. They must be based on knowledge of consumer needs and demand, as well as the desire to meet those needs safely and responsibly over the long term. No single provider can meet all consumer needs; there is value to variation and choice in the marketplace. Finally, providers and consumers must both act responsibly for healthy financial relationships to flourish.

Regulation is critical, but not sufficient, for restoring credibility to the idea that financial services can be a force for good in people's lives. Banks must demonstrate that they can self-regulate their worst impulses if they are to regain the trust of consumers and policymakers. Nonbank providers have long suffered from the perception that they are either second-class institutions or predators, or both. Some indeed are, but many represent potentially positive alternatives. They, too, need a way to demonstrate a commitment to quality products and practices if they are to be viewed as trustworthy. Technology-led providers may be today's darlings, but they are the most lightly regulated in the financial services marketplace, and they have lost points over their recent handling of customer privacy and security issues.

Trust is essential for positive innovation to flourish. We need innovation to replace the corroded pipes of the financial services system with an infrastructure that is modern, high quality, and inclusive. Only then will underserved consumers have the tools they need to shore up their own finances.

JENNIFER TESCHER *is the president and CEO for the Center for Financial Services Innovation, which aims to transform the financial services experience in America in order to better serve underbanked consumers and help them achieve prosperity. Ms. Tescher founded CFSI in 2004 and has since achieved notable success in raising the profile of underbanked access and asset-building as an objective for the industry. Ms. Tescher serves as a member of the Board of Directors for Credit Builders Alliance and is a member of Bank of America's National Community Advisory Council. A recipient of the Crain's Chicago Business "40 Under 40" Award for 2006, Ms. Tescher received undergraduate and graduate degrees in journalism from Northwestern University and a public policy degree from the University of Chicago.*