RESEARCH

Economic Watch

US

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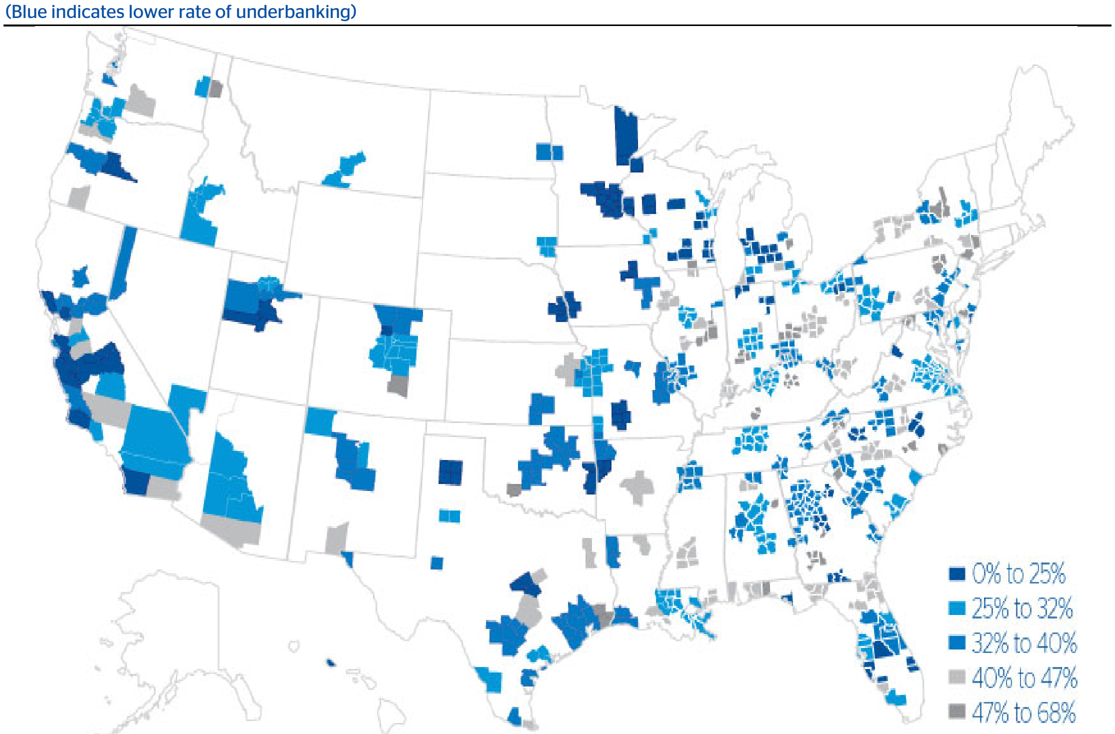
Economic Analysis

US
Boyd Stacey
boyd.stacey@bbvacompass.com

A Closer Look at America's Underbanked

- As of 2009, nearly 25.6% of the population was not receiving full service from traditional finance, with 17.9% underbanked and 7.7% unbanked
- FDIC data suggests effectively little usury activity and that choice represents the primary motivation for AFS usage
- Education and income are key determinants of being unbanked however, for the underbanked, education and income are appear less correlated with financial outcomes
- Constraints from Dodd-Frank on commercial banks will indirectly or directly impact services for both the unbanked and the underbanked
- Market-based offerings satisfy only part of the underbanked, while nonprofits and microfinance round out the remainder of offerings outside the regulated perimeter

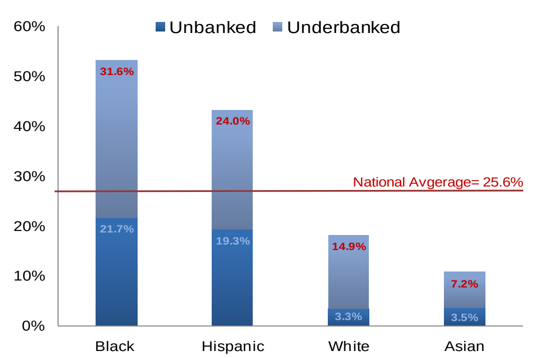
Chart 1
Underbanked*
(Blue indicates lower rate of underbanking)



Source: FDIC& BBVA Research *2009

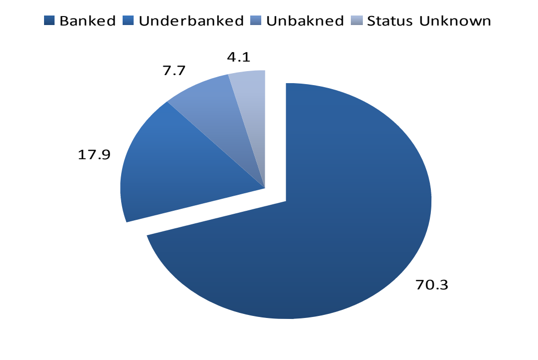
There is extreme variability in terms of banking population dynamics with regard to alternative financial services. As of 2009, nearly 25.6% of the population was not receiving full service from traditional finance, with 17.9% underbanked and 7.7% unbanked, of which half own neither a checking nor a savings account. The FDIC classifies underbanked by use of AFS while also owning a traditional checking or savings account. The unbanked population is defined as those without active checking or savings accounts. For simplicity, this analysis treats the underbanked as the overarching group with the unbanked as a subcomponent, although there are overlapping data points.

Chart 2
Households Banking Status
(Grey=Underbanked, Blue= Unbanked)



Source: FDIC

Chart 3
Underbanked Population
(% of Total)

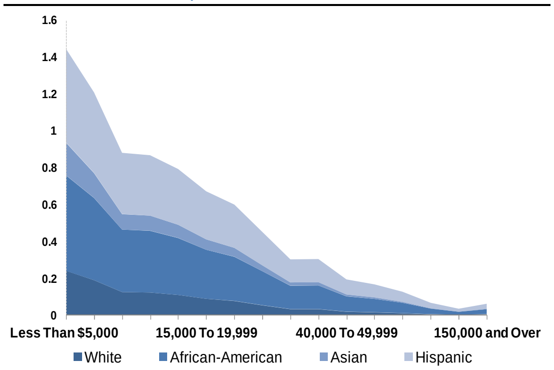


Source: FDIC

As defined by the FDIC, AFS include nonbank money orders, nonbank check-cashing, pawn shops, payday loans, rent-to-own agreements (RTO's) and refund anticipation loans (RAL'S). Contrary to popular perception, many usurious services including RAL's and payday loans have limited market share. For example, only 2.6% of all respondents reported using refund anticipation loans with an additional 2.3% reporting RTO use. To be clear, a refund anticipation loan is a tax refund collateralized loan, which carries high pecuniary cost. Payday loan use is similarly low among the unbanked and underbanked, with roughly 3% households reporting use. However, more traditional bank-related services, including check cashing and money orders, elicit higher use. The high utilization of money orders and check cashing services outside the traditional financial system highlights an important counterfactual trend. Previous hypothesis posited that the absentia was compulsory. However, experimental research and the FDIC survey suggests these nonbank service provide sufficient, or in some instances, optimal utility, representative of various preferences including desire to remain financially anonymous, convenience or non-pecuniary cost. Furthermore, the use of predatory alternative financial services is low, suggesting the underbanked may avoid usury fees more often than originally suspected.

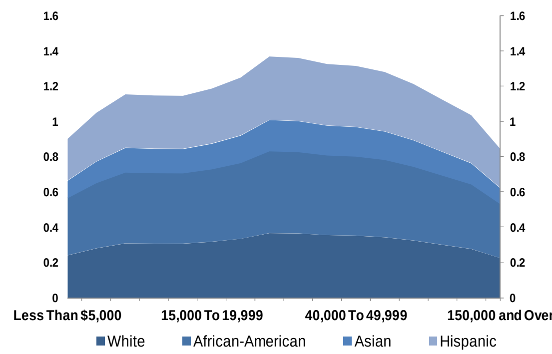
Significant variation exists among the underbanked and unbanked when observed across, race, region, or income. By the FDIC's definition, the unbanked population represents those who currently own neither a checking nor savings account as a household. The national average was 7.7%, of which approximately half had previously been either underbanked or fully banked. The unbanked, which comprise 7.7% of the population, have a higher probability of being of lower income, a minority, or having low educational attainment. In other words, these individuals are underserved financially and possibly inequitably treated. On average these individuals are minorities with lower income and education. Of the population with a college degree, only 1.2% is unbanked, compared with 24.5% of those without a high school degree. The distribution is less drastic for the underbanked. For example, the probability of being underbanked for someone with a high school diploma is the same for someone with a bachelor's degree. For income, the marginal effect is equally diluted among the underbanked. For those who are earn 75k a year, the probability of being unbanked and underbanked are 0.9% and 30.7%, respectively. However, the intra-marginal variation is strikingly different. Earning 75K suggests an individual is 6.3% less likely to be unbanked as opposed to someone earning 20-25K, whereas 0.9% is the average difference for the underbanked. In other words the income distribution for the underbanked is significantly skewed to the right and decays exponentially compared with the underbanked which displays a more normal distribution.

Chart 4
Income Distribution for Unbanked
(Cumulative Probability)



Source: FDIC & BBVA Research

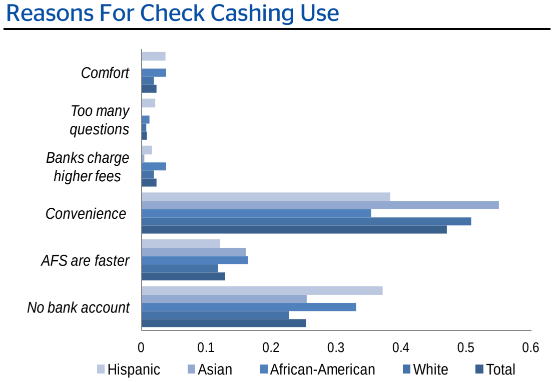
Chart 5
Income Distribution for Underbanked
(Cumulative Probability)



Source: FDIC & BBVA Research

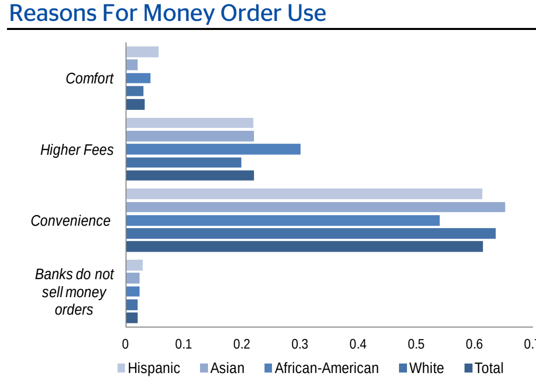
For the unbanked, income and education are key determinants of financial participation, which is suggestive of economic exclusion, however, the underbanked –which are defined by AFS use – are explained less by socioeconomic outcomes and more by choice. While part of the FDIC questionnaire focused on alternative financial use, the other part detailed the type of AFS used, reason for use, and amount of uses per year. The distribution of responses for why each individual used money orders and check cashing services was overwhelmingly because of convenience (47.1% and 67.4%). Moreover, a Detroit study found that having a bank account does not imply absentia from alternative financial services markets; being unbanked does not exclude households from using mainstream financial services and, contrary to popular belief, being unbanked is not a permanent financial outcome. The FDIC responses and current research suggest there is a group who choose exclusion because of low utility, price perceptions, low wealth, convenience, or the non-pecuniary costs of banking. Additionally, the low utilization by the group suggests that the significant attention these services attract from policy makers may be unjustified.

Chart 5
Reasons For Check Cashing Use



Source: FDIC

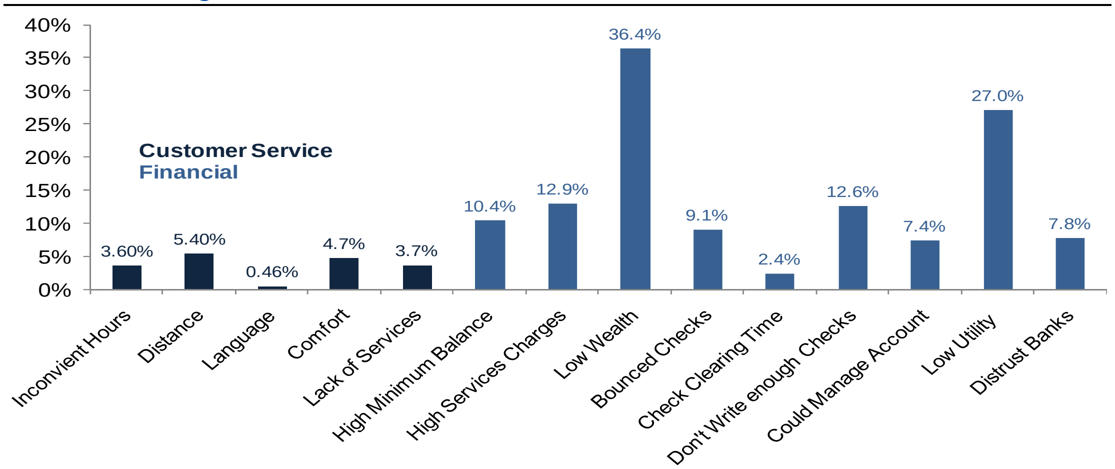
Chart 6
Reasons For Money Order Use



Source: FDIC

Regulatory changes, specifically the Dodd-Frank Act, will impact commercial bank balance sheets and margins and either directly or indirectly effect services provided to underbanked individuals. For example, banks are responding to decreased transaction margins and nullified overdraft fees with monthly maintenance charges. Since fee services would financially exclude many LMI individuals, it is not likely that the underbanking problem will decline during this period. In addition, after-effects of the 2008 financial crisis suggest banks will reduce traditional services and branch presences in low-to-middle income areas regardless of regulation. Current language enacted in the Dodd-Frank bill provisions for the underbanked and underfinanced. The provisions imply that AFS corporations of $10bn in assets or greater will fall under the regulatory oversight of the newly appointed committees. In addition, the office of minority and women inclusion, a consolidated consumer protection branch and the office of financial literacy will be created to statutorily address the underbanked and microfinance concerns. Both of the later appear consistent with underbanking improvement, while the office of the minority and women inclusion appears congruent with microfinance.

Chart 8
Reasons for Closing Account



Source: FDIC

Current market-determined offerings are satisfying part of the underbanked market, while non-profit microfinance initiatives are trying to round out the underbanked financial offerings outside of federal regulation. Firstly, microfinance is lending done to borrowers not traditionally serviced or given the opportunity to borrow. The structure of these loans varies but traditionally they are community-guaranteed, have high interest rates, and target female borrowers. One example is the Kiva program which acts as an intermediary between borrower and lender, providing a PayPal like service. Some primarily for-profit businesses charge high fees for some services to LMI individuals. Examples like Sam's Club, Wal-mart are moving against the high cost trend, providing a more equitable and transparent market for AFS consumers. Generally, AFS, including RALs, payday loans and RTO's are associated with predatory lending practices, and should receive increased scrutiny. It is difficult to predict the market trend but it appears there is a growing number of successful for-profit and non-profit offerings within the underbanked market that provide fair and equitable services.

Bottom line: Underbanking is unlikely to be a problem of the past

There are 21.2mn individuals who draw on AFS, a majority of which cite convenience as the reason for use and thus many are underbanked by choice. Alternatively, the services catering to their desires may not yet exist due to technological limitations. In addition, approximately 9mn people have neither a checking nor a savings account. The reasons for absentia vary but primarily they are due to low utility or low wealth. Furthermore, of the respondents who reported using AFS, only a small portion indicated that they elicit usurious alternative financial services, meaning only a small portion of the population fall prey to predatory finance. Nevertheless, public policy makers are targeting this issue suggesting further policy intervention is forthcoming. Current Dodd-Frank legislation regarding underbanking is either lacking in specifics or weakly provisioned, which suggests that current regulation will do little to change the statutory requirements of the Community Reinvestment Act. In other words, barring any dramatic shift the underbanked will continue to draw on alternative financial services in a partially-regulated market.

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