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# Targeting the Unbanked – Financial Literacy’s Magic Bullet?

David Godsted and John A. Tatom

Adult financial illiteracy is a major problem in the US and elsewhere. Financial fraud and poor performance in managing personal finances go hand in hand.<sup>1</sup> The nation’s bankruptcy and home mortgage foreclosure rates have continued to climb<sup>2</sup> despite improving employment opportunities, rapid growth in the nation’s income and bankruptcy reform aimed at making bankruptcy filing less necessary and more difficult. America’s personal savings rate hovers in negative territory.<sup>3</sup> As new financial services and technologies proliferate, many low income persons are being left in the dust, often unable to participate in cost saving or high-return opportunities, or they are offered new services only on very unfavorable terms. At the same time, lack of financial and technological safeguards has made it easier to exploit all individuals through identity theft, mortgage fraud, or legal, but financially dubious, new products. In some cases, new technology is being forced on low-income individuals by a coordinated federal push for electronic payment of benefits. While an imposition on the otherwise unbanked, increasing access to financial institutions may provide a useful introduction to a higher level of financial information and literacy, as well as enhancing their confidence and ability in financial management.

Recently, H&R Block developed an innovative scheme for providing cash advance loans against income tax refunds that were used to fund new IRA bank accounts for the tax payers. These programs offered new opportunities for saving and investment, especially for low-income individuals. They connected unbanked individuals to the payments system and organized saving programs, in many cases, for the first time. Nonetheless, precisely because low-income people were the biggest beneficiaries of the plan, the plans came under strong scrutiny by

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<sup>1</sup>Fighting Financial Fraud: How to Shield Yourself from Swindles. 2003. *FDIC Consumer News*, Spring, 1-2. The Spring 2003 issue of the *FDIC Consumer News* details strategies for becoming a defensive consumer to protect against identity theft and deceptions involving credit cards, ATMs, other bank products and the internet.

<sup>2</sup> Nationally, foreclosures in the first quarter of 2006 increased 38% over the fourth quarter of 2006. See Roger, R “Foreclosures drop locally, rise elsewhere.” (2006, June 9). *Bradenton Herald*. Bankruptcy rates in 2006 have declined slightly from the inflated levels in the first half of 2005, prior to new bankruptcy laws taking effect. For the 12-month period ending June 30, 2005, a total of 1,637,254 bankruptcies were filed, while in the 12-month period ending June 30, 2006, 1,484,570 bankruptcies were filed. See <http://www.uscourts.gov/bnkrpctystats/bankruptcystats.htm>.

<sup>3</sup> The savings rate has been in negative terrain since the second quarter of 2005. See U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts Table, Table 5.1, Saving and Investment.

regulators for their promised low rates of return and high costs that are typical of small deposit accounts. As a result, their development was slowed. In September 2006, however, the company announced a program to open low-cost bank accounts for free to one million clients and to reduce the cost of anticipation refund loans for the 2007 tax season.<sup>4</sup>

Congress has also begun to address the perceived market for attaching the unbanked and other low income-individuals to the financial system in order to develop better spending and saving habits and provide access to lower cost means of payment. Such efforts are critical for addressing the growing problem of financial illiteracy. In particular, Senate Bill 1321, as recently amended, includes provisions to improve financial education through tax preparation help and to increase the availability of saving and checking accounts for individuals. Equally noteworthy, financial education and assistance with access to financial services would be facilitated by upgrading and extending the work of community assistance institutions, broadening their portfolios to include personal financial planning and management services.

Large numbers of people do not have bank accounts. According to Professor Robert Lerman, there are 25 to 56 million adults who do not have access to a checking or saving account.<sup>5</sup> A recent Federal Reserve study says that 10.2 percent of families did not have a checking account in 2004, the latest data available, down from 12.7 percent in 2001. The former figure is about 11.4 million families or, based on the population averages of 2.57 people per household, about 29.3 million people, closer to the low end of the range cited by Lerman.<sup>6</sup> Michael Barr claims that some 83 percent of the unbanked earn less than \$25,000 per year.<sup>7</sup>

People are unbanked for many reasons, including lack of proximity to a bank, high cost, or personal preference. Somewhat surprisingly, availability and cost are not the main reasons. Bucks, Kennickell and Moore (2006) show that in 1995, 1998, 2001 and 2004, the main reason why families did not have a checking account was that they "do not write enough checks to make it

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<sup>4</sup> Rauber, K (2006, September 7). "H&R Block Announces Plan to Open 1 Million Bank Accounts for Free And Significantly Cut the Cost of Refund Lending." [http://www.hrblock.com/presscenter/pressreleases/pressRelease.jsp?PRESS\\_RELEASE\\_ID=1459](http://www.hrblock.com/presscenter/pressreleases/pressRelease.jsp?PRESS_RELEASE_ID=1459)

<sup>5</sup> See Robert I. Lerman and Elizabeth Bell, "Financial Literacy Strategies: Where Do We Go From Here?" Networks Financial Institute *Policy Brief*, 2006-PB-10, April 2006.

<sup>6</sup> See Brian Bucks, Arthur B. Kennickell and Kevin B. Moore, "Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances," *Federal Reserve Bulletin* February 2006, pp. A1-A38.

<sup>7</sup> See Michael S. Barr, "Banking the Poor: Policies to Bring Low-Income Americans Into the Financial Mainstream," The Brookings Institution *Research Brief*, September 2004.

worthwhile" (27.9% in 2004). However, in 2004, families that "do not like dealing with banks" (22.6%), the second most common reason since 1998, and "do not need/want an account" (5.2%), together exceed the limited usefulness reason. On the other hand, cost was the reason for 11.6 percent who said that minimum balance requirements were too high and for 5.6 percent who said that service charges were too high. Only 1.1 percent of families gave as their primary reason that there was no bank "with convenient hours or location." In a study covering 1995, Hogarth and O'Donnell (1999) examine these same reasons that lower income families do not hold checking accounts, but they also break out families that do not use financial institutions at all.<sup>8</sup> Among this group (i.e. no checking or saving account, or other services) the principal reason given is "Don't have enough money" (32.9 percent), followed by "Don't write enough checks" (23.1%) and then "Don't like dealing with banks" (20.2%). Cost and availability are less important reasons for those who are completely unbanked than for those who use banks but do not have a checking account. Distaste for banks is about the same for both groups, and lack of funds is more important for the unbanked.

### **The New Senate proposal (S.1321)**

On June 28, 2006, the Senate Finance Committee amended Senate bill 1321 (hereafter S.1321), "Telephone Tax Repeal Act of 2005," a bill to repeal the excise tax on telephone and other communications and to provide greater financial literacy education, tax preparation and financial services access through financial service providers or community charities. The Bill was subsequently placed on the Senate's legislative calendar in September 2006. Essentially, the committee incorporated the text of S.832, which provided for these new services, into S. 1321, as a substitute amendment, and reported S. 1321 favorably. The amendment, or new component, reads as follows:

(a) Establishment of Program- The Secretary is authorized to award demonstration project grants (including multi-year grants) to eligible entities which partner with volunteer and low-income preparation organizations to provide tax preparation services and assistance in connection with establishing an account in a federally insured depository institution for individuals that currently do not have such an account.

New Mexico Senator Jeff Bingaman introduced the S. 832 legislation, and had this to say:

The last section of the bill [S. 832] is an issue that my colleague from Hawaii, Senator Akaka, has been actively working on for the last several years. This provision would authorize the Treasury Department to award

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<sup>8</sup>Jeanne M. Hogarth and Kevin O'Donnell, "Banking Relationships and Lower-Income Families and the Government Trend toward Electronic Payments," *Federal Reserve Bulletin*, July 1999, pp. 409-73.

grants to financial institutions or charitable groups that help low income taxpayers set up accounts at bank or credit union. Because many taxpayers do not have checking or savings accounts, their refund from IRS cannot be electronically wired to them. The alternative is to have the check mailed to the taxpayer or to have the refund immediately loaned to the taxpayer in the form of a RAL [refund anticipation loan]. Of course, getting people to set up a checking or savings account for purposes of receiving their tax refund will also have the benefit of getting many of these people to start saving for the first time <sup>9</sup>

Unfortunately, the Senate bill was not acted upon in the 109<sup>th</sup> Congress. It can be expected to be introduced in winter 2007 in the next session of Congress, however.

### **Networks Financial Institute Position**

Networks Financial Institute wholeheartedly supports the passage of this measure, but cautions Congress that it needs to be viewed as a small step that treats one symptom of financial illiteracy.<sup>10</sup> It is critical that we reach a far deeper understanding of the root causes of why people make the personal financial choices that they do.

In an attempt to inculcate sound financial management approaches early in life through its Kids Count financial literacy curriculum, NFI introduces the key concepts of financial literacy to 3<sup>rd</sup>-5<sup>th</sup> grade children:

- Goal setting
- Earning
- Budgeting
- Saving
- Spending
- Giving

These concepts form the building blocks of financial literacy, and they remain critical through adulthood. In addition, NFI is working with a national panel of experts to further refine its set of K-12 financial literacy competencies into a set of adult standards. Legislation that fosters the development of these key concepts, promotes age appropriate national financial literacy standards, and

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<sup>9</sup> Bingaman, J (2005, April 18). Written statement of Senator Jeff Bingaman upon the introduction of S. 832, the Taxpayer Protection and Assistance Act of 2005. Web site: <http://www.natptax.com/s832statement.pdf>

<sup>10</sup> Since these provisions are embedded in a broader effort to improve economic wellbeing, we should recognize that the telephone tax was passed as a temporary measure in 1898 to fund the Spanish-American War! Support for this component of the bill hardly warrants discussion, but it could be noted that the tax is one of the highest and most regressive excises that low-income taxpayers face.

uses these standards to predict at-risk groups and to create tailored solutions stands the best possible chance of stemming the rising tide of financial illiteracy.

### **Key Positive Implications of S.1321**

The First Accounts program, which began in 2002, provides evidence that the unbanked respond to programs to extend banking services to them.<sup>11</sup> S.1321 will go much further by providing an educational base to efforts to provide bank access to the unbanked. It creates an incentive for the unbanked to adopt and use banking services through the linking of tax refunds to bank accounts, especially savings accounts and perhaps eventually IRA accounts. In addition, a public plan could offer higher rates of return and lower cost options than recently developed private sector plans. Most importantly, the bill provides the incentive for a fundamental shift in the focus and mission of charities and community services toward providing education in developing financial literacy and assistance in taking up mainstream private sector financial services.

First Accounts and state efforts through Lifeline accounts rely on price incentives to induce the unbanked to take up bank services. However, Bucks, Kennickell and Moore (2006) show that cost is not the principal factor accounting for the number of unbanked. Similarly, Doyle, Lopez and Saidenberg (1998) show that efforts to lower the cost of accounts through mandated Lifeline accounts have had “limited impact” because often banks already were offering lower cost accounts than the new mandated accounts, or because the unbanked were unresponsive to price changes.<sup>12</sup> According to Doyle et al, the unbanked rely on alternative services that provide immediately available funds more rapidly than banks so that check cashing is more attractive elsewhere than at banks, even though more expensive. S.1321 does not rely on lowering the cost of financial services, nor is it a program that is focused on payments services. S.1321 shifts focus to saving and wealth accumulation and hence has greater long-term benefits for low income individuals and the unbanked.

The new proposal, S. 1321, also promotes access to electronic banking and it encourages individuals to directly take up a banking relationship. Existing government programs for benefit payments and tax refunds do not require that individuals actually have bank accounts and many have been able to avoid them through alternative finance arrangements or state government sponsored plans

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<sup>11</sup> A review of the First Accounts program is contained in David Marzahl, O.S. Owen, Steve Neumann and Joshua Harriman, “First Accounts: A U.S. Treasury Department Program to Expand Access to Financial Institutions,” Center for Economic Progress, published in Federal Reserve Bank of Chicago, *Profitwise News and Views*, February 2006. Only one round of grants was made in 2002 to create these accounts and no funds have been provided since then.

<sup>12</sup> See Joseph J. Doyle, Jose A. Lopez, and Marc R. Saidenberg, “How Effective Is Lifeline Banking in Assisting the ‘Unbanked’?” Federal Reserve Bank of New York *Current Issues* 4, No. 6, June 1998.

that receive the payments and earn income from the float, without benefit to the individual.<sup>13</sup>

The bill also takes advantage of the most significant and widely accepted conclusion of “behavioral finance” research: individuals are more likely to respond to new saving incentives if the default is participation with the right to drop out than if they are offered the option to join. S. 1321 envisions a framework in which the tax preparer creates an account for the individual to receive refunds. Individuals could later close the account, but given that the funds are safely received and held in the account, they are more likely to keep the account and use it. It would be beneficial if S. 1321 were expanded in the next session of Congress to provide a differential incentive to create and fund a saving-type account, especially an IRA or other tax-free or incentivized account, if the goal is to improve financial literacy and long-term wellbeing of the unbanked.

The key risk of the new accounts proposed under S. 1321 is that there is high reputational risk in arranging accounts for low-income persons. The recent charges against H&R Block for arranging a similar type of product could potentially limit participation by charities or financial institutions in the program. The use of government subsidies could allow better pricing terms to alleviate some of that risk, though ultimately the fact that it is a government-sponsored program is probably better insurance against reputational risk. In the end, this program could go further, tying together responsible suppliers of personal financial education and the unbanked in a program that transfers tax preparation skills and management of personal banking products to low-income individuals and extends banking services along with saving and wealth building programs to the unbanked. Such a comprehensive and multi-faceted program is an important step in promoting financial literacy among the unbanked and not simply trying to push them into greater access with mainstream checking accounts. We strongly support the provisions of S.1321 and their expansion as a key step in federal efforts to promote financial literacy.

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<sup>13</sup> Hogarth and O’Donnell (1999) detail the benefits of the trend toward electronic banking and the benefits to low income households.