white paper

FICO

Serving the Unbanked and Underserved

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» Summary

Approximately 17 million adults in the US are unbanked, meaning they have no relationship with a depository institution. Another 43 million are estimated to be underserved, meaning they may have a banking relationship but do not utilize it effectively and rely on non-bank providers for basic financial services. Worldwide, the unbanked population is estimated at 2.5 billion. For financial institutions, this represents enormous potential. Yet the value of this market is not well understood and largely underestimated, and banks are challenged with figuring out how to serve it profitably without undue risk. By understanding the needs of the market, overcoming barriers to entry and using tools such as FICO® Deposit Behavior Scores to monitor risks, banks stand to realize growth opportunities from this market while furthering the cause of greater financial literacy and participation worldwide.

» Introduction

Who are the unbanked? There are two distinct subpopulations that are often mistakenly blended together and labeled "unbanked." The actual **unbanked** are those who have rarely or never held a transaction account, including checking, savings or check cashing, at any depository institution. These individuals either have no credit bureau files or, in some instances, have a thin file opened by a single inquiry. In contrast, the **underserved** have or have had a depository account with a financial institution, but tend to rely more on non-bank financial services for transaction accounts, check cashing or high cost credit products.

The distinction is important, since the two groups have very divergent needs and demographics, and they are responsive to different marketing approaches. People in these groups have either no FICO® Score or a FICO Score supported by a very thin file, often void of credit payment activity or utilization. From a banking perspective, while these groups have significantly different needs and characteristics, the primary issues related to serving them are similar, including:

- The need for education, outreach and financial literacy.
- The industry's general perception of what defines these groups and the degree of market opportunity they represent.
- Barriers to access and interaction with a financial institution.
- The need to comply with account opening policies, such as "Know Your Customer".
- Specific products and services that meet the unbanked or underserved consumer's needs.
- Funds availability when cashing payroll checks or making deposits.
- The need for affordable entry level credit products.

The World Bank describes the key issues for reaching and serving the unbanked as access and literacy. For most of the unbanked, the primary barrier to an established checking product may be verification of identity. Individuals may not have access to documents to prove their identities or may not understand what is required. In addition, if going to a bank branch or ATM is inconvenient, the unbanked will choose to transact in cash. There are several outlets available for the unbanked to cash a payroll check, such as grocery stores, check cashing stores, pawn shops or convenience stores that get to know and identify the unbanked customer over time.

In contrast to the needs of the unbanked, banks have strict regulatory requirements when opening a checking account. Know Your Customer (KYC) regulations require that financial institutions check the identity, background and other aspects of the source of funds of any potential customer. The legislation requires evidence of the customer's identity at account opening and a record of that evidence kept as long as there is a relationship with that customer. The principal aim of the KYC regulation is to prevent money laundering and fraud. To comply with KYC, 99% of US banks require a driver's license to open a checking account and 92% require a passport. A small number of US banks (27%) will accept a Matricula Consular card from Mexico to open a checking account.

Assuming the identity hurdle can be met and the account opened, only 62% of US banks have products that do not require a minimum balance. Around 90% of US banks offer free check writing in their most basic checking account product.

Many of the unbanked population do not understand the requirements for opening and managing a basic transactional account, nor do they understand pricing and terms. Bank services available to unbanked individuals who do not or cannot meet the identity requirements include bank checks, money orders or, in a small number of banks, international remittances.

» Who Are the Unbanked and Underserved?

A recent survey sponsored by the FDIC[1] found that in the United States, 7.7% of the population was unbanked. This amounts to 9 million households nationally, or approximately 17 million adults. Nearly 18%, or 21 million households (approximately 43 million adults), were found to be underserved. The survey determined that the proportion of unbanked US households varies considerably across racial and ethnic groups, with certain groups more likely to be unbanked than the population as a whole, as shown in Figure 1.

FIGURE 1: PERCENTAGE OF DIFFERENT ETHNIC GROUPS UNBANKED AND UNDERSERVED

Racial/ Ethnic Group	Unbanked Percent	Underserved Percent
African American	21.7%	31.6%
Hispanic	19.3%	24.0%
American Indian/ Alaskan	15.6%	28.9%
Asian	3.5%	7.2%

A higher percentage of African American, Hispanic and Native Americans tend to be unbanked or underserved than other ethnic groups or the population as a whole.

Source: FDIC National Survey of Unbanked and Underbanked Households, December 2009

Income was also a key factor in the likelihood of being unbanked or underserved. Households with less than $30,000 in income comprised 71% of the unbanked responses. The concentration of unbanked is estimated to be 20% of lower income US households or 7 million adults earning less than $30,000. In the $30,000 to $50,000 income range, 4.2% were identified as unbanked, while only 1% were so identified in the $75,000+ income group.

Internationally, estimates for the unbanked are much higher. A recent McKinsey report[2] estimated that 59% of the world population is unbanked. This represents over 2.5 billion adults, mostly from Africa, Asia, Latin America and the Middle East.

The unbanked and underserved are often mislabeled as "un-bankable" because they are viewed as high credit risks. Often, however, these households and individuals either have lower access to mainstream financial services, less education and lower financial literacy, or have barriers to entry due to identity verification, location, policy or current banking regulations. Because they usually experience declines due to credit policy first, credit risk is rarely assessed formally for these groups. As we have observed in other emerging groups, such as student accounts, credit risk may be higher for the population segment overall, but due to variability in risk, there are still more good customers than bad.

» Providing Access for the Unbanked and Underserved

Conventional wisdom in developing access for the unbanked has taken two distinct and prominent channels: debit prepaid cards and mobile banking. Both channels have seen limited success.

Debit Prepaid Cards

The Network Branded Prepaid Card Association (NBPCA) and the Center for Financial Services Innovation[3] conducted a survey of 400 unbanked adults who had used reloadable prepaid debit cards to determine perceptions of the product. The majority of the group surveyed was happy with the product and would recommend it to others. For the most part, the card provided a sense of security in that the cardholder did not need to carry cash, and the product was convenient to use with local merchants.

Products such as gift, reloadable, travel and other prepaid cards have come under regulation by the Credit Card Act that includes disclosure requirements and the allowance of fee assessments based on inactivity or monthly usage. In a few cases, the consumer is protected from lost or stolen cards or fraudulent transactions and charge-backs. In most cases, however, there is no such protection, which makes the card equivalent to using cash. In addition, merchants pay interchange fees on the transactions. Drawbacks for these products include lack of visibility into the available balance and generally no recourse for unauthorized transactions or lost cards. In addition, transactions requiring a hold on funds do not commonly accept these cards. Cardholders receive no paper statements reporting their usage or balances. The information is usually available only online. Access to computers and the internet creates another barrier for these individuals, as does a lack of education and the lack of reporting that would assist them in developing financial acumen.

With prepaid cards, the average transaction amount is approximately $10. Such cards serve a distinct market purpose, but may not be the product of choice for developing financial literacy among the unbanked and underserved populations.

Mobile Banking

Despite regulatory challenges, policymakers worldwide are embracing mobile banking as a means of providing financial access to the unbanked or underserved. More than a billion people worldwide lack bank accounts, but have mobile phones. This provides a unique opportunity to achieve greater financial inclusion and literacy for these populations.

"Mobile banking services offer millions of poor people a route out of poverty by helping them to improve their incomes and pay for healthcare and education," said Mike Foster, UK Minister for International Development. "It is vital that policymakers ensure that the needs of the poor are central as they develop regulation for this innovative and emerging sector."

Elizabeth Littlefield, CEO of Consultative Group to Assist the Poor (CGAP)[4], a World Bank microfinance center, echoed the sentiment saying, "Mobile banking holds great potential, and CGAP is encouraged to see that governments everywhere are being deliberate and thoughtful as they merge the domains of finance, payments, and telecom to create a framework that balances customer needs with concerns around security and prudential regulation."

Mobile banking, also referred to as branchless banking, has emerged in Argentina, Bangladesh, Brazil, Colombia, Egypt, India, Kenya, Maldives, Mexico, Pakistan, Peru, the Philippines, Russia, Rwanda, Sri Lanka, South Africa, Tanzania and Zambia. In the US, mobile banking adoption has grown exponentially from an estimated 400,000 users in 2007 to over 10 million in 2009. TowerGroup estimates there will be 53 million US mobile banking users by 2013. Today, the top 300 US banks either currently offer mobile banking or plan to launch a mobile banking channel.

Some of the barriers identified by CGAP for financial institutions implementing mobile banking include:

- Allowing nonbank third parties, such as local merchants, to conduct "cash-in/cash-out" transactions and interact directly with customers.
- Adapting the rules for anti-money laundering and combating the financing of terrorism (AML-CFT) so that they are based on real risks and the realities of transactions conducted through remote agents.
- Identifying the correct regulatory space for the issuance of e-money and other stored-value instruments, particularly when issued by parties other than fully licensed and supervised banks.
- Determining how to ensure effective consumer protection on a variety of fronts.
- Ensuring that the payment systems are open to all players and adequately supervised.
- Balancing bank competition policies—providing the right incentives for pioneers to get into the mobile banking business without allowing customer-unfriendly monopolies.

In addition, financial institutions are looking for more robust capabilities and answers to such issues as:

- Applying and understanding risk management in the mobile banking channel.
- Executing cross sales and next-best offers to improve access and profitability.
- Providing education and support for the unbanked and underserved populations.
- Using text alerts for overdraft disclosure and opt in/opt out capabilities.
- Reviewing daily balances.
- Retaining records of transactions performed each day.
- Providing general access to ATM locations.
- Enabling mobile payments.
- Providing off-line banking management.

E-Wallets

E-wallets are an emerging payment vehicle enabling paperless and non-plastic transactions through an inter-banking platform. Currently provided throughout the Americas, the offering is multilingual and multicurrency. The advantage of being multilingual is in helping develop literacy and trust in situations where language may be a prominent barrier to entry into financial services.

The platform is carrier neutral. Financial institutions interact as members of the payments network, which provides banks with opportunities to participate in mobile banking payments. The network offers person-to-person, person-to-business, and business-to-business payment interactions. E-wallet services are often offered via the Internet and are compatible with the majority of mobile phone models. The financial institutions' cost of entry is low, and end-users and merchants pay a minimal per-transaction charge. This charge may be further reduced in the future with all-inclusive monthly rates for unlimited usage much like mobile phones.

E-wallet networks provide a lower cost option for processing remittances and other funds transfers across borders while still maintaining oversight of OFAC and money laundering regulations. Users can easily monitor transactions and balances on most mobile phones. They are also protected from charge-backs and theft.

» Growing Wealth and Raising the Standard of Living

Once the unbanked and underserved gain access and education has begun, the offering institution's next objective should be to support the consumer's financial growth and promote loyalty. This requires establishing a risk metric for use in transaction management and future cross-sale opportunities.

Starting the relationship with credit may be the norm for the US financial culture, but it has dangerous implications when risk assessment is either missing or thin[5]. Fortunately, FICO® Deposit Behavior Scores are a unique and appropriate way of determining the customer's or account's source and use of funds. This score helps determine the growth or loss of deposit activity and identifies balance turn and debit activity. Improving scores over time can help the financial institution evaluate the consumer's readiness for other products such as micro loans, installment loans or even revolving products. The score becomes the leading indicator of risk, providing the institution with key information to evaluate whether the consumer is ready to move to credit products. Included in the score is the payroll deposit or direct deposit data that provides a good measure of the consumer's income and stability.

Financial institutions need to understand the needs of the unbanked and underserved around access, financial literacy, social acceptance, attitudes and relationships as they establish deposit and credit accounts. By producing and monitoring a deposit behavior score, a financial institution can help those previously unbanked or underserved to manage and grow their wealth and improve their standard of living. In return, the bank gains loyalty, recognition and significant profit opportunities.

» Predation and Victim Fraud: Protecting the Unbanked and Underserved

Predatory lending is not new to the financial industry. The unbanked and underserved, however, are particularly vulnerable to it. The former Comptroller of the Currency, John D. Hawke Jr., stated, "History has shown us again and again that where conditions of financial stress exist, there will always be predators—those who charge exorbitant prices to the most vulnerable members of society for services that the more affluent receive for less."[6] Building services and long-term relationships with the unbanked and underserved requires an understanding of potential predatory practices and why these people fall prey to them. As Mr. Hawke stated, "We must target not just the predators themselves, but the conditions that allow them to flourish." Those conditions include the traditional barriers to entry into mainstream financial services, which send people to check cashing and payday loan[7] outlets for basic services. Mainstream financial institutions offer these populations advantages over fringe providers, yet so many who need the services don't have access or choose not to utilize them.

Advantages of mainstream financial institutions include lower costs for basic transaction needs; helping to build personal wealth in a safe and consistent way; inexpensive and efficient payment services; development of formal credit histories; and developing relationships that can lead to affordable mortgages, small business financing or education loans.

Fringe operators do provide a range of payment services in one location. They are convenient for cashing paychecks, low-cost money orders and postage stamps, and serve as agents for utility bill payments and electronic money transfer services, such as Western Union. The issue with these services is their high cost. Most providers charge 2% to 3% of the value of a check being cashed. A family with $18,000 in take-home pay who uses such check cashing services regularly can spend $400 or more of its limited annual income just to obtain basic payment services.

Banks inadvertently drive the unbanked to these services. The inability of someone to cash a paycheck at a bank with no checking account, or without enough funds in the account to cover the check, creates a barrier. The process might be easier if the check is cashed at the originating bank, but that still requires the individual to have access to that bank.

Opening balances can also create a barrier to entry. These populations are more likely to live from paycheck to paycheck and have a higher probability of bouncing a payment, incurring non-sufficient funds (NSF) costs that average $27 for each instance in the US. These groups have little margin for the unexpected and will tend to miss scheduled or regular payment obligations when stresses occur.

Problems in their credit history and debt-to-income burdens often leave the unbanked and lower-income households cut off from mainstream credit. These households turn to fringe sources of credit out of necessity for short-term loans to meet emergencies. The APR for such loans can be over 100% and often as high as 500%.

Fraud is of particular concern for the unbanked and underserved. Around the world, many financial institutions utilize a merchant or employer intermediary to provide financial access to isolated, rural or impoverished areas. These intermediaries have direct access to both the unbanked individuals and the financial institution funds and contracts. Obtaining accurate verification that an unbanked consumer is receiving the correct terms, interest rates and amounts of a credit product is often beyond the supervisory capacity of the financial institution and left to the intermediary. A consumer in India, for example, may be eligible for a loan in the amount of 50,000 rupees at 20% APR, but instead receives only 10,000 rupees at 40% APR. The consumer's lack of education and inability to read or understand the financial statement or contract can lead to fraud on the part of the intermediary, causing greater mistrust and problems for the unbanked as well as reputational risk for the financial institution.

» How to Begin

There are number of steps a financial institution can take to begin acquiring and growing currently unbanked customers:

- Bring banking to the consumer through kiosks or common retail relationships, such as supermarket banking.
- Provide staff at these outreach locations with incentives, time and materials to explain and demonstrate the process, helping consumers establish deposit accounts and walking them through their first purchase.
    - If the banking channel is mobile banking, help consumers understand how to check their balances, make a purchase, check recent transactions and generally monitor their accounts.
    - Help consumers understand how to protect their account and funds from theft or fraud.
    - Make a person available to address future questions either at the location or by phone.
    - Determine if a consumer has a payroll check that can be deposited automatically into his or her account and explain how that is accomplished.

- Give the consumer a period of time to understand how the process works.
  - Track activation and usage, check for further deposits.
  - If the customer is not utilizing the account, reach out through communication channels to see why and determine what the consumer may need.
  - Limit initial usage to the consumer's funds. Do not offer overdraft products (if available by regulation) initially.
  - Develop the deposit behavior score to help determine risk, monitor performance and balance growth.
  - Make the funds available determination using the deposit behavior score and average available balances. Protect the consumer from bad deposits that are likely to encounter deposit holds, offering funds availability as soon as possible.
- Monitor and offer credit products that match the risk and value growth of the consumer.
  - Segment the population and begin with credit products that help support the consumer's standard of living realistically, such as:
    - Installment loans for appliances and durable goods.
    - Micro loans for business development.
    - Small and controlled revolving products.

These approaches reflect a high-touch customer service strategy based on growing both the consumer's knowledge and personal wealth. The economic benefit for the financial institution is the long-term relationship and customer loyalty.

What basic services do the unbanked and underserved need?

- Fee-based check-cashing services for non-customers.
- Money orders or transaction payment processing that is inexpensive and easily obtained.
- Savings accounts.
- Deposit accounts with savings links or rewards.
- Easily accessible education programs to understand account balancing, savings and basic credit terms and products.

» Conclusion

Providing services for the unbanked and underserved is not a short-term, quick-profit strategy. It is an investment that provides long-term growth and cross-selling opportunities while fulfilling the institution's commitment to help consumers grow their personal wealth and standard of living. The rate of growth and penetration will vary by consumer. Monitoring performance and balances through deposit behavior scoring, analytics and segmentation enables the institution to identify candidates for cross-sale offers at the right time, in order to manage risks while building the long-term relationships.

An investment in services for the unbanked and underserved pays many dividends, not only in profitability for the institution, but also in reducing rates of poverty, financial ignorance and inaccessibility around the world. The commitment is well worth the effort.

References

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3. *New Data on Prepaid Card Usage and Underbanked Consumers*, www.nbpca.com.
4. CGAP is an independent policy and research center dedicated to advancing financial access for the world's poor. It is supported by over 30 development agencies and private foundations that share a common mission to alleviate poverty. Housed at the World Bank, CGAP provides market intelligence, promotes standards, develops innovative solutions and offers advisory services to governments, microfinance providers, donors and investors. www.cgap.org.

   CGAP's Technology Program is supported by the Bill and Melinda Gates Foundation.
5. Giving Credit Where Credit Is Due: Serving the Underserved in the United States Through Insight into the European Credit Culture, Tiffany Doob, August 2009.
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7. Payday loans, also called deferred deposit loans, are short-term cash advances based on the borrower's personal check or debit authorization held for future deposit. These loans are made at payday loan outlets, check cashers, rent-to-own stores, pawn shops or via the Internet.

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