CFSi Center for Financial Services Innovation
An Affiliate of ShoreBank Corporation

Testimony of Melissa Koide, Policy Director
Center for Financial Services Innovation

Before the Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Comptroller of the Currency
Office of Thrift Supervision

Public Hearing on the Community Reinvestment Act Regulations
August 6, 2010

Thank you for the opportunity to discuss the Community Reinvestment Act and its ability to improve low- and moderate-income consumers' access to financial products and services. I will address how financial services activities should be considered under the CRA and what regulatory changes would encourage financial institutions to expand access to safe and affordable transaction and savings accounts and small-dollar credit to low- and moderate-income consumers, in a safe and sound way.

My name is Melissa Koide, and I am the policy director of the Center for Financial Services Innovation (CFSI). CFSI is a national nonprofit organization in its sixth year of providing leadership, research, and insights on the financial services needs of underserved, underbanked consumers. We conduct consumer and industry research to develop a broad understanding of consumers in this segment and the products offered to them. We make investments in nonprofits and for-profits serving underbanked consumers with financial products and services that are beneficial to consumers and sustainable for providers. And we develop and advance federal financial services policy to spur product innovation and market competition and to address impediments to high-quality financial services access. We work with banks, credit unions, technology vendors, nonbank financial service providers, consumer advocates, academics, and policymakers to forge relationships, products, strategies, and public policy in an effort to transform industry practice and improve the lives of underbanked consumers.

We believe there is a central role for the CRA to play in encouraging innovation, enhancing competition, and increasing the availability and use of safe and reasonably priced financial products and services for underserved, low and moderate-income consumers.

Prior to joining CFSI, I worked at the New America Foundation and the Center for Economic Development on financial services policies, and before that in the Office of Community Development Policy in the U.S. Treasury Department. At Treasury we fought for and succeeded in keeping the CRA intact under the Financial Modernization Act of 1999, or what became known as the Gramm-Leach-Bliley Act. I was also charged with managing the creation of the report titled *The Community Reinvestment Act After Financial Modernization: A Baseline Report*, mandated by Congress in 2000.

It was a little over a decade ago, in fact, that policymakers and thought leaders began to contemplate the transaction, savings, and small-dollar credit needs of low- and moderate-income consumers. Many of us believed that access to a bank account was the missing ingredient that, if present, would lead to increased financial stability and ultimately financial prosperity for these consumers. We also believed that consumers did not have bank accounts largely because banks were not physically present in their communities.

While those assumptions were not completely wrong, we have since learned that the financial lives of low- and moderate-income consumers are just as complex and multifaceted as the financial lives of middle- and upper-income households. And while a bank account may indicate a household's increased likelihood for savings and wealth building, many other factors must be considered. Through seminal financial services surveys of low- and moderate-income and underbanked consumers, a multitude of consumer focus groups, and a handful of financial services pilots over the past decade, we have come to know the following about low- and moderate-income consumers' financial services activities:

First, 21 million consumers who already have bank accounts are nevertheless using a variety of nonbank financial services, products, and approaches to meet some—often most—of their financial services needs. These alternative strategies include:

1) Converting a check into cash via a check-casher
2) Accessing a payday loan to bridge an income shortage
3) Over-withholding income taxes in order to meet a savings goal and pay off an outstanding debt or an overdue bill with a tax refund
4) Using a money transmitter service to remit money to family and friends in other locations
5) Using money orders to pay bills, such as rent, utility payments, and other expenses

Second, low- and moderate-income consumers often elect to use nonbank financial services firms, even when there is a bank in close proximity.[1] And even though these choices may seem uneconomical, when compared to direct alternatives which often include high, unexpected fees (such as over drafting fees), they may not be. Moreover, many of these services have transparency, reliability, convenience, and they offer liquidity and ease of use that can far outweigh what may seem like disproportional costs.

The check-casher offers immediate, convenient check-to-cash conversion at a price that is clear, upfront, and without unexpected fees that can arise days after the transaction was made. The payday loan store offers a virtually guaranteed source of short-term credit, and access to the loan is quick and available without requiring a good credit score or probing questions. Over-withholding one's federal income tax payment is a means of "forced" savings. It may not be economically rational, but it is a safe method to plan financially and safeguard against future expenses. Paying bills via money orders and transmitting money via remittances services are effectively a just-in-time money management strategy, using products that are convenient, transparent, and guaranteed to work.

Third, we know that no matter what their attractive features, these products often come with high costs either directly through fees or indirectly through the structure of the products. With payday loans, for example, consumers often end up being trapped by escalating debt, without the benefit of building a credit history. In fact, the use of payday loans can hurt a consumer's ability to open a bank account and access more traditional forms of credit. Check-cashing and remittance services lack linkages to savings options and credit building features.

And finally, we know that banks themselves have not sufficiently developed products and services that meet low- and moderate-income consumers' financial services needs at affordable prices. For many years,

[1] Matt Fellowes and Mia Mabanta, *Banking on Wealth: America's New Retail Banking Infrastructure and Its Wealth-Building Potential*, The Brookings Institute, January 2008; accessed July 2010 at http://www.brookings.edu/~/media/Files/rc/reports/2008/01_banking_fellowes/01_banking_fellowes.pdf.

banks asserted they could not profitably serve low- and moderate-income consumers, who usually maintained low balances yet made a high number of transactions. More recently, banks have shown more interest in the segment, covering costs through high fees directly on accounts. A 2009 FDIC bank survey showed that virtually all banks were charging non-sufficient funds fees (on average $27 per overdraft) and that almost half of all banks (41%) had a minimum balance requirement of between $161 and $185. For a sense of the typical account balance of a low- and moderate-income consumer, consider that the average balance of a prepaid debit product used by these consumers hovers below or near $100. Until the recent overdraft rules were enacted, the overdraft fees, albeit exorbitant, were to some extent subsidizing the low-balance accounts, as well as rewards programs directed at higher-income customers. It remains an open question how low-balance customers will be served under the traditional bank account model.

THE EVOLVING ROLE OF BANKS IN PROVIDING FINANCIAL SERVICES FOR LOW- AND MODERATE-INCOME CONSUMERS

There are nevertheless promising transaction, savings, and small dollar credit products that banks may offer directly or indirectly that are beneficial for consumers and sustainable for providers. Depending on their size, structure, and market niche, banks can play a variety of roles to address the range of consumers' financial services needs. In addition to providing and servicing transaction and savings products directly, banks can serve as wholesalers of products that are distributed through nonbank entities, nonprofits, and retail channels. Banks can help to enhance and grow the market by providing working capital to other entities that distribute the financial services to low- and moderate-income consumers. Banks can scale up the number of good products by providing back-office processing and other vendor services to firms that interface with the consumers directly. In all cases, well-constructed CRA incentives could further encourage bank participation and innovation in serving the financial services needs of the consumers.

Transaction and Savings Products

I want to say a few words about some of the transaction, savings, and small dollar credit products and the different roles of banks in providing these financial services. One transaction product with considerable potential given its functionality and convenience is the general purpose reloadable prepaid card, or simply prepaid card. Prepaid cards are pre-funded accounts that are capable of a range of financial transactions, including point-of-sale purchases, ATM withdrawals, on-line bill payment, and remittances. They may also offer savings capabilities, money orders, access to wages and government benefits, as well as credit features. Prepaid products provide the benefits of checking accounts with debit cards, but without the barriers of ChexSystems and credit checks that prevent millions of consumers from accessing traditional bank accounts. Plus, they are readily available through a wide range of convenient venues, including bank branches, retail stores, as well as nonbank financial service providers.

While banks do not directly interface with consumers in offering these products, they do play a central role in providing the products by issuing the cards and holding the cardholders' funds. Other nonbank financial firms, including program managers, processors, and payments networks create the accounts, process the transactions, and provide the electronic rails for the transactions to occur. Today, there are millions of low- and moderate-income consumers using prepaid cards as their primary transaction product.

Banks are also providing and promoting savings products in both direct and indirect ways. Most institutions offer a basic savings account. Others, however, are participating in more inventive savings strategies targeting low- and moderate-income consumers. For example, a pilot is underway now to initiate and facilitate savings among lower income consumers through the workplace. Participating banks issue savings accounts to employees, whereby the employers initiate access to the accounts and facilitate the automatic savings deposits through the payroll process.

City-led and community-based initiatives are also providing consumers with savings and transaction products, with nonprofits and city agencies serving as the intermediaries that connect consumers to the accounts. And in a direct to consumer savings program, US Bank has rolled out an automatic savings sweeps program, whereby customers pre-set an amount to be routinely swept from their checking account into a savings account. Once the customer's savings account reaches $1,000, the customer receives a $50 gift card. The program, while aimed at all customers, emerged out of conversations on how to encourage and facilitate savings among low- and moderate-income consumers using sweepstakes and other compelling savings incentives.

Small-Dollar Credit Offerings

Access to small dollar credit is a pressing financial services need of low- and moderate-income consumers, and this is an area that warrants fuller attention under the CRA. CFSI research shows that almost one-third of the 30 million U.S. households who are unbanked or underbanked are borrowing to pay for small-dollar, short-term needs. A significant portion of those borrowers are doing so to cover basic expenses. Where credit cards were once used by many to meet unexpected expenses and to help bridge income shortages, the recent financial crisis and credit crunch have made credit less available to consumers with subprime credit scores. Recent analysis by FICO shows that "25.5 percent of consumers—almost 43.4 million people—now have a credit score of 599 or below, marking them as poor risks for lenders."[2]

Nevertheless, there are some great examples of banks providing both indirect and direct to consumer small dollar loan options. As shown with the FDIC's small-dollar loan pilot, banks can provide small-dollar credit options directly to consumers. The products typically take the form of installment loans and secured credit products. The banks making these loans as sustainable business lines are typically community banks and credit unions that serve minorities and lower-income consumers and often use a range of nontraditional credit data to underwrite the product. For instance, El Banco de Nuestra Comunidad, based in Georgia, targets the underbanked Hispanic market and provides a variety of credit products designed for customers with little or no credit history. El Banco underwrites loans to these borrowers using a range of nontraditional credit data, including check-cashing activity, money transfers, bill payments, prepaid card and bank account usage, rental history, employment verification, and length of residence in the United States.

However, when it comes to significantly expanding the availability of safe and affordable loans at a scale that can truly affect market competition and price, it may be as important for banks to play indirect roles as it is for them to offer the products directly. Banks for example can provide capital to responsible lenders, which then enables those lenders to leverage the funds and expand the number of good loans that are available. The creation of the loan loss reserve fund for small dollar loans in the Dodd-Frank bill is one such way that policymakers have recognized the indirect way that banks can help to scale and expand the number of responsible lenders. In other cases, banks may develop and distribute responsibly designed loans through intermediaries, including employers and local nonprofits. And in other ways, banks can actually purchase loans from nonbank lenders, thus freeing up resources and enabling growth. Citibank, for example, has purchased tranches of micro-loans from ACCION Texas to enable the nonprofit to expand its loan offerings. While I am quite sure Citibank received CRA credit for this, this is a powerful example of how banks could help to expand the availability of good small dollar credit options for low- and moderate-income consumers. These are all approaches to small dollar lending that could be significantly augmented with CRA credit.

THE NEED TO MODERNIZE THE CRA TO IMPROVE FINANCIAL SERVICES

It is time to modernize the CRA to take into account what we know about low- and moderate-income consumers and the lack of safe and affordable transaction, savings, and credit products in the marketplace. The CRA can be better leveraged to expand the quantity and quality of these financial services.

---

[2] Andrew Jennings, chief research officer for FICO in Minneapolis. Historically, just 15 percent of the 170 million consumers with active credit accounts, or 25.5 million people, fell below 599. See Myfico.com.

We have seen over the past two decades how the CRA has boosted the availability of mortgage and small business lending because of the existence of the CRA and the weight the CRA gives to those activities. The same cannot be said for financial services. Overall, the Service Test is a relatively modest component of the overall CRA exam. More specifically, the CRA currently places much of its financial services emphasis on the existence of and the opening and closing of bank branches in low- and moderate-income geographies. This fails to recognize the vast reach of large financial institutions, the growing prevalence and value of internet banking, and the increasing opportunities to deliver products and services through nontraditional channels like retailers, employers, nonbank firms, and others. To be sure, the CRA does allow for alternative retail delivery methods, such as EBT cards. But because of the weight given to bank branches, credit for more innovative strategies and products that may require significant systems and technology investments is undervalued.

More now than ever there is a policy imperative to change the CRA to induce and reward banks for meeting the financial services needs of low- and moderate-income consumers with financial services that are safe, affordable, sustainable, and credit building. This includes rewarding banks for directly providing these services and for indirect activities whereby banks not only help to scale good products, but also help ensure that consumer protections reach consumers. So how can the CRA recognize and encourage an expansion of safe and affordable financial products and services, consistent with safe and sound practices? Here are a few recommendations.

RECOMMENDATIONS TO EXPAND AND ENHANCE THE AVAILABILITY OF SAFE AND AFFORDABLE FINANCIAL SERVICES THROUGH CRA REFORM

1) Provide CRA credit to banks for directly and indirectly expanding access to safe and affordable financial services.

The CRA should reward banks for directly and indirectly providing low- and moderate-income consumers with access to safe and affordable transaction, savings, and small-dollar credit products. Moreover, the CRA should place greater emphasis on the actual provision of and use of high-quality financial services. This can be achieved by strengthening the Service Test and by offering banks a new, dedicated strategic plan option for institutions that would like to focus a significant share of their CRA activity on these financial services.

A dedicated strategic plan option focused on financial services would enable banks that are heavily engaged in these activities to tailor their CRA obligations to reflect that focus. It would require institutions to set out what their goals are for meeting the financial services needs of the consumers they serve, along with details about resources, business strategies, and capacities for meeting those goals. It would give banks incentives to both directly and indirectly offer quality financial services, and it would give banks through the multi-year plan the assurance that a dedicated strategy aimed at financial services for low- and moderate-income consumers would be valued and rewarded.

A strategic plan option focused on financial services could also give banks the room to test new products, technologies, financial capability tools, and delivery channels, with extra attention for creativity around products and strategies that thoughtfully seek to meet low- and moderate-income consumers' needs and overcome various impediments to financial access.

The result should be more prolonged and sustainable efforts by banks to meet the financial services needs of low- and moderate-income individuals. Banks that opt for this plan would still be required to present their lending and investment activities in their assessment areas. And like the strategic plan option that currently exists, this plan would include measurable annual goals by which the bank would be assessed, as well as a public comment period.

In addition to providing a strategic plan option focused on financial services, policymakers should revise the Service Test to 1) strengthen it in the overall CRA exam, 2) reflect and reward banks for the different ways they can engage in and expand access to financial services, and 3) increase the focus on the delivery of good products, which is described in the following recommendation.

Financial services research over the past decade has made it very clear how important safe and affordable transaction, savings, and credit products are for low- and moderate-income consumers. Access to well-priced transaction products can result in significant savings over a lifespan, compared to high-cost alternatives. Access to and use of savings products can serve powerful safety nets when unexpected expenses arise. And access to affordable, responsibly-structured credit can be a financial bridge when other options are unavailable, while also building good credit histories, essential for longer-term wealth building. It is time for the CRA to reflect the importance of these services, and a strengthened and more heavily weighted Service Test would enable that.

We recommend that the CRA be revised to foster both quality and quantity of financial services in the marketplace by giving CRA credit for good products that are offered directly and indirectly to low- and moderate-income consumers. By extending CRA credit for bank activities like indirect services and lending through nonbanks, nonprofits, and others, regulators would be helping to substantially scale the availability of good products for low- and moderate-income consumers at large. Furthermore, expanding the Service Test to allow credit for indirect services through other entities builds on the precedent in the investment and lending tests that allows banks to earn CRA credit for making investments and loans through other entities.

2) Give credit for financial services that are safe and affordable.

Encouraging financial services providers to serve low- and moderate-income consumers without taking into account the quality of services can lead to bad results for consumers, banks, and the economy, as was clearly demonstrated with mortgages. The goal is not just that products and services be available but that those products and services be safe, affordable, and sustainable. Especially when a bank is given credit for providing services indirectly, regulators need to be able to assure themselves and the public that the ultimate service provider is enhancing, not reducing, financial stability.

Accomplishing this goal will not be easy. It is in large part a matter of examiner training and judgment against a set of standards that will take time to develop. But we can suggest several criteria to consider. Are the fees on transaction products clear and transparent and reasonably related to cost? Are savings products designed so that principal is not lost to fees? Are small-dollar credit products designed to prevent over-indebtedness and realistically enable repayment? Bank regulators have access to a huge amount of information about the products that banks make available. In deciding whether to provide credit for financial services, and especially in evaluating strategic plans focused on financial services and deciding whether to give credit for indirect services, regulators could take advantage of that information and explain in the public evaluation what they find.

We also suggest that CRA regulators work closely with the Consumer Financial Protection Bureau. This Bureau will have a substantial role in understanding the product offerings in the marketplace. Ideally those responsible for CRA and the CFPB would coordinate and share data and learnings to identify strategies and policies to increase low- and moderate-income consumers' access to useful financial services and products—enhancing achievement of the goals of both statutes.

3) Ensure the CRA is responsive to changes in the financial services marketplace.

Technology advances, product innovations, enhanced data and analytics, as well as new access channels like the mobile phone, suggest that the modes by which consumers access financial services will continue to evolve, with significant changes for how banks interface with low- and moderate-income consumers and how those consumers behave in the financial services marketplace. For example, the increasing likelihood of the mobile phone serving as a central financial device will likely dramatically alter how consumers conduct their financial activities. The personal computer, which is increasingly serving as a primary portal for personalized financial information and advice, may radically change how consumers acquire and use financial services. And new channels for selling financial services – such as the retail store – could substantially change where financial services are sought and accessed by low- and moderate-income consumers.

The CRA has been a powerful policy lever to ensure low- and moderate-income consumers have access to mortgage products. With the CRA changes that you are currently contemplating, the CRA can be further leveraged to expand access to good transition, savings, and small dollar credit products. It is essential, however, that banking regulators continue to reflect and calibrate the regulations and examination practices to maximize the CRA's strength and responsiveness to new insights into low- and moderate-income consumers' needs and preferences, as well as industry developments.

CONCLUSION

Over the past ten years, our knowledge about underbanked consumers has become much more sophisticated, our understanding about the financial services sector and the underlying economics have become much clearer, and our understanding about the availability of safe and affordable financial products has deepened. This is a critical moment for the Community Reinvestment Act regulations to be updated to reflect the state of the financial services marketplace. We appreciate very much your willingness to face this difficult, but essential task.