

Innovative Financial Tools for Serving the Underbanked:

A Summary

Christy Chung Hevener, M.G.A.
Federal Reserve Bank of Philadelphia

Marvin M. Smith, Ph.D.
Federal Reserve Bank of Philadelphia

The views expressed here are those of the authors and do not necessarily represent the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

The views expressed by the presenters are their own and do not necessarily represent the views of their respective organizations.

**TABLE OF
CONTENTS**

- I. Introduction 5
- II. Serving the Underbanked: State of the Industry 5
- III. Prepaid Cards: A Substitute for the Checking Account? 7
 - Panel Presentations 8
 - Identifying a Market Opportunity for Prepaid Cards 8
 - Implementing the Program 9
 - Discussion 11
- IV. Innovation in Consumer Credit: Alternatives to Payday Lending 13
 - Panel Presentations 13
 - Discussion 15
- V. Alternative Credit Data: Reaching Untapped Markets 17
 - Panel Presentations 18
 - Discussion 20
- VI. Closing: Insights from KeyBank’s Approach 21
- Conference Agenda 23
- Institutions Represented at the Conference 24

I. Introduction

The term underbanked has been increasingly used to describe the roughly 40 million households in the U.S. who either do not have a banking relationship or have a limited banking relationship with a mainstream financial institution.¹ Many of these underbanked consumers rely heavily on fringe financial service providers, including check cashers and payday lenders, to conduct routine financial transactions, and pay high fees in the process.

However, the emergence of new products and services, such as prepaid cards, has broadened the menu of financial services available to the underbanked. Nonprofit organizations, among others, have adopted these new financial products as a way to provide financial services to their members at a lower cost. This trend in the marketplace has spurred dialogue and debate regarding the role of these products for the underbanked. Some of the concerns raised include:

- Are these products destined to be substitutes for mainstream financial products, or do they serve as starting points that enable the underbanked to graduate to traditional products?
- Are there pitfalls with using these new products?
- Which features do the underbanked value most?
- Should public policy encourage the widespread adoption of these alternative products, and if so, how can widespread adoption be achieved?
- Can these services be provided more cheaply and at scale?
- Can these products be profitable?

To enhance understanding and increase knowledge about these issues, the Federal Reserve Bank of Philadelphia and the Center for Financial Services Innovation (CFSI) co-sponsored a conference on October 16, 2007, entitled “Innovative Financial Tools for Serving the Underbanked,” that brought together representatives from nonprofit organizations, credit

¹Technically speaking, the term “unbanked” is used to characterize the former group and “underbanked,” the latter. However, in some instances, the term “underbanked” is applied to both groups of consumers, which is the case here.

unions, and banks to describe the products and programs they have created to serve the underbanked. The conference covered three main topics: prepaid cards, alternatives to payday lending, and alternative credit data. The Bank and the CFSI convened three panels of experts to provide background on these subject areas and to facilitate a discussion. In their presentations and during the general discussion, the panelists provided valuable insight on what they have learned about the underbanked segment of the consumer market and the challenges and rewards of creating, marketing, and distributing an alternative product to service their needs.

II. Serving the Underbanked: State of the Industry

Jennifer Tescher, director of the CFSI, provided the overall context for the conference. In her remarks, she described several developments that have had an impact on the state of the financial industry, developments that, in turn, have led to the industry’s growing interest in the underbanked as a new market segment. She noted that some of the developments are derived from changes in technology, the demographic makeup of the U.S., the structural shifts in the industry, and the performance of the economy. Other influences can be linked to growing research on the nature of wealth building and actions taken by the government to find alternative mechanisms to provide federal benefits.

Tescher suggested that one underlying factor that influenced the financial industry’s increased focus on the underbanked stemmed from growing research that highlights the connection between people’s income and their assets, which in combination allows them to achieve financial prosperity. According to the research, a person’s income is essential, but the investment of that income in building assets is critical in reaching a goal of affluence. Mainstream financial services figure prominently in the process of accumulating assets through the products they offer — such as assisting in establishing and maintaining a retirement account or a home mortgage — and they are interested in expanding their client pool. The role of traditional financial services providers is particularly noteworthy, since the

underbanked are generally unable to take advantage of such providers' asset-building capability. This makes it more difficult for the underbanked to ultimately attain prosperity. Given this situation, it stands to reason that the pursuit of the patronage of the underbanked by traditional financial services providers would be mutually beneficial.

Another contributing factor, according to Tescher, can be traced to actions on the part of the federal government. In the late 1990s, when the government tried to distribute federal benefits to recipients electronically, it discovered that millions of recipients were unable to receive benefits, since they lacked a bank account. This drew attention to the existence of a sizable segment of the population that needed special consideration by the government and mainstream financial institutions to enable them to participate in the government's electronic delivery of benefit payments.

A third contributing factor was advancements in technology and the entrance of new competitors into the financial services industry, which prompted financial entities to take a look at attracting the patronage of the underbanked. Tescher pointed out that changes in technology in the payments industry are evidenced by the dramatic increase in the ease with which consumers can access their money to conduct business from a vast number of locations and in a variety of ways while incurring low transaction costs. She suggested that these enhancements in the industry could offer opportunities for reaching the underbanked.

While acknowledging the increase in the number of payday lenders, Tescher hastened to add that there also has been a substantial increase in the number of nonbank companies in the financial marketplace. These new market players, Tescher observed, underscore the potential monetary gains to be realized in providing financial services to the underbanked.

Tescher also pointed to the dramatic demographic shift in the country as reflected in the 2000 census and the financial services industry's reaction to the changes. She recalled that the industry was quick to respond to the business opportunities presented by the influx of Latino immigrants. Tescher

suggested that some of the same strategies that the financial services industry employed to acquire the patronage of the Latino immigrants might be used to target the underbanked.

In view of the focus on efforts to provide the underbanked with increased opportunities in the financial services industry, Tescher thought it was only appropriate to acknowledge a contrary position that centers on the dramatic rise in overspending by consumers. She noted that the nation's growing indebtedness, as manifested most recently in the subprime crisis in the mortgage market, might be viewed as a possible indication that consumers, including the underbanked, may have access to too much credit, rather than too little — a theme that resonated throughout the conference.

Tescher also voiced a note of caution when making generalizations about the underbanked. She stressed that the underbanked segment represents diverse demographics and preferences. Thus, care should be exercised in using broad strokes to generalize their financial behavior.

In closing, Tescher briefly outlined the topics covered in the conference. She noted that conference organizers considered many areas of innovation but chose to focus on three areas in which a great deal of progress has been made. The first is prepaid cards. Tescher indicated that they are gaining popularity as a potentially valuable financial instrument that possesses some attributes that are attractive to the underbanked. In contrast to bank accounts, prepaid cards provide immediate liquidity and a greater degree of convenience. In addition, they are more difficult to overdraw. However, Tescher observed that some unresolved issues surrounding prepaid cards have hindered their widespread use.

The second subject area concerns the emergence of innovative products that meet the short-term credit needs of consumers. In the wake of the decline of finance companies and the dearth of small-dollar signature loans by banks, Tescher noted that these new products are a welcome addition to the financial marketplace and serve as alternatives to payday lending.

The last topic deals with the quest for alternative credit data that could assist in evaluating the creditworthiness of consumers with thin or no credit files with the major credit reporting agencies. Today, a consumer's credit score determines access to a host of services. In view of the heavy reliance on credit scoring, Tescher emphasized the need to develop alternative data sources to aid the 35 to 50 million consumers who currently do not have a credit score.

Finally, Tescher noted that Mike Griffin from KeyBank would end the conference by discussing KeyBank's efforts to attract the underbanked.

III. Prepaid Cards: A Substitute for the Checking Account?

Sherrie Rhine, of the Office of the Comptroller of the Currency, served as moderator for the first panel, which included Tam Doan, of the Center for Community Change; Patricia Hasson, of the Consumer Credit Counseling Service of Delaware Valley; and Jeremy Smith, of the Service Employees International Union. To set the stage for the panelists' discussion, Rhine provided a brief primer on prepaid cards. She began by discussing prepaid cards in the context of other card-based products, such as credit and debit cards. Next, she focused on the comparative advantages of checking accounts and prepaid cards by contrasting some key features of each. Then she approached the question of product substitutability: the idea that prepaid cards can serve as substitutes for checking accounts for certain financial transactions. After Rhine's presentation, the panelists shared their organizations' experiences delivering prepaid card programs.

According to Rhine, prepaid cards can perhaps be best understood when compared with more traditional card forms, such as credit cards or debit cards, with the overriding distinction among the three hinging on the timing of payment. As the name suggests, prepaid cards are based on the "pay early" model, which requires cardholders to pre-load funds onto their prepaid cards before the cards can be used to make purchases or payments. In comparison, credit cards are based on the "pay later" model, generally

granting credit card holders a grace period of around 28 days to pay for their purchases. In contrast, debit cards are based on the "pay now" model, where the funds to pay for purchases are drawn directly from a checking account linked to the debit card.

Rhine cautioned that because of the dynamic growth taking place in the prepaid card market, consumers should be aware that not all prepaid programs are alike. Prospective users of prepaid cards should exercise due diligence and understand the various terms (such as the services offered, pricing and fees, and consumer laws and regulations) of the particular prepaid cards under consideration. Rhine also noted that if a bank issues a company's prepaid card, consumers might become confused. For example, if a problem arises, it might be unclear whether consumers should contact the prepaid card company in order to resolve the problem or the bank that issued the card on behalf of the company.

In her discussion, Rhine paid particular attention to branded prepaid cards: cards branded with the Visa, MasterCard, American Express, or Discover logo. Rhine observed that there are payroll cards and general spend cards, each distinguished by how it is obtained by cardholders. Payroll cards, for example, reach cardholders through their employers, who generally load, or deposit, their employees' paychecks onto the card on payday. In contrast, cardholders obtain general spend cards by purchasing them through retailers such as marketers, distributors, or sellers of prepaid cards.

Turning to the question of how well prepaid cards can serve as substitutes for checking accounts, Rhine considered whether prepaid cards offer the same level of services or consumer protections as checking accounts. She examined several features associated with checking accounts, including funding methods (direct fund transfer and on-site loading of funds), withdrawal methods (automatic bill payment and electronic bill payment), consumer protections (overdraft protection and FDIC insurance), and other benefits (a springboard to other financial products or services and an indicator of creditworthiness). Rhine noted that prepaid cards offer some, but not all, of these features. For example, for services associated with funding the accounts, Rhine observed that prepaid cards generally offer direct

fund transfer, while only some offer on-site loading of funds. Similarly, for services associated with withdrawing funds, prepaid cards normally offer automatic bill payment, but only a few offer electronic bill payment. Turning to consumer protections (overdraft protection or FDIC insurance) and to other benefits (access to other financial products or services or the opportunity to establish or augment a customer's creditworthiness), Rhine reported that prepaid cards seldom offer these features, although some do.

The thrust of the analysis is that the precise bundle of features and services offered by prepaid cards depends on the particular prepaid card program. Rhine acknowledged that the vast array of prepaid card products is symptomatic of a nascent, dynamic, and evolving industry with a continual supply of new market players, each with prepaid card products whose features and fee structures vary. This, she said, makes it difficult to describe, in a general way, whether prepaid cards offer the same services mentioned above. Furthermore, the pace at which the industry is evolving suggests that the mix of features offered today will not likely be the same mix of product features offered tomorrow. Rhine suggested that, in the future, prepaid cards can evolve to offer features that better resemble those of checking accounts.

Rhine also broached the subject of implementing consumer protections. She pointed out that with any growing industry, there is usually a question of whether regulation is needed. One concern is that regulation might hinder innovation and growth. In terms of prepaid cards, the challenge, according to Rhine, is to devise some degree of consumer regulations while allowing for innovation. She ventured that some of the concerns dealing with possible protections afforded to consumers involve Regulation E.² In particular,

² Subsequent to the conference, an article by Frederick Lowe discussed the Federal Reserve Board's consideration of extending consumer protection to prepaid cards. According to a Fed spokesman quoted in the article, "Network-branded, reloadable prepaid cards would receive the same protection that Regulation E of the EFT Act provides employer-issued payroll cards." See Frederick H. Lowe, "Fed May Expand Reg E Protections to Consumer-Purchased Prepaid Cards," *ATM & Debit News*, 9:8 (February 26, 2009).

she noted that an attempt to provide users of prepaid cards the same level of protection as that enjoyed by consumers with checking accounts might include such questions as: How often and in what manner should consumers receive account statements? What types of options for dispute resolution are available to consumers? Are consumers' funds protected by FDIC insurance? And much like the concerns associated with checking accounts, can prepaid cards be used for anti-social behavior such as money-laundering?

Panel Presentations

Following Rhine's presentation, panelists in the first session shared with the audience the motivations that prompted their organizations to undertake a prepaid card program, the challenges that arose from implementing such a program, and the insights gleaned from the overall process. Tam Doan, of the Center for Community Change (referred to here as the center),³ began the panel discussion by articulating the two main objectives that nonprofits hope to achieve by offering a prepaid card program: to offer a valuable service to the organizations' members or customers and their families and to strengthen the organizations' financial sustainability by establishing another source of revenue. The other panelists underscored these same two motivations as primary reasons for their organizations' adopting a prepaid card program. The discussion among the panelists dealt with two general areas: identifying a market opportunity for prepaid cards and implementing the program.

Identifying a Market Opportunity for Prepaid Cards

The panelists generally agreed that a crucial first step in adopting a prepaid card program is to evaluate the need for the product among the organization's members or customers. According to Doan, the center uncovered such a financial need when it surveyed the

³ The Center for Community Change is a nonprofit organization based in Washington, D.C. that works with grassroots organizations nationwide to advocate for basic needs for their constituents such as housing, education, and health care; the center also deals with such issues as immigration and foreign workers' rights.

financial behavior of the constituents of the grassroots organizations (or “worker centers”) they work with. The population served by the worker centers mostly comprises immigrants and day laborers. The center found that half of those surveyed were unbanked, while another sizable segment used fringe products and services such as check cashing, money orders, and money remittances to conduct their financial transactions. The results of the survey⁴ appeared to confirm the center’s hypothesis that prepaid cards had the potential to offer significant cost savings, convenience, safety, and other benefits to the worker centers’ constituents.

Patricia Hasson, of the Consumer Credit Counseling Service of Delaware Valley (CCCSDV),⁵ identified a market opportunity for prepaid cards among participants of CCCSDV’s debt management plans and individuals who receive free tax filing at VITA sites through the Campaign for Working Families partnership. She noted that participants in debt management plans were required to destroy their credit cards to demonstrate their commitment to reducing debt. But they could use prepaid cards to approximate the conveniences of a credit card, without the features that facilitated the accumulation of large amounts of debt. Hasson also saw a potential role for prepaid cards to enable program participants to circumvent check-cashing fees during tax season by encouraging them to deposit their refunds on prepaid cards. Until now, efforts to encourage tax filers to open free checking accounts in order to deposit their tax refunds electronically have failed to gain traction, in part because of the length of time it takes for financial institutions to open new accounts at the tax sites.

⁴ The study was sponsored by the CFSI and the Ford Foundation.

⁵ CCCSDV is a nonprofit organization with eight branches across the Delaware Valley, including counties in Pennsylvania and New Jersey, that has offered consumers from every income level “comprehensive consumer credit education, counseling, asset building and debt reduction programs” for more than 40 years.

⁶ The SEIU, one of the fastest growing unions in North America, represents workers in industries as diverse as health care, long-term care, property services, and the public sector.

Jeremy Smith, of the Service Employees International Union (SEIU),⁶ indicated a need for prepaid cards to augment the SEIU’s traditional suite of products and services. According to Smith, the SEIU initially thought that prepaid cards could be linked to a program to provide access to health care among its low-wage members. But the union developed a more comprehensive strategy that included a focus on asset-building as well as opportunities to lower the check-cashing and money-transfer fees paid by unbanked members. Smith also noted that prepaid cards had the potential to advance current organizing activities by facilitating payments for members who were on strike or traveling to other locations.

Implementing the Program

The panelists emphasized the importance of selecting an industry partner adept at navigating the technical aspects of a prepaid card program, including establishing a contractual agreement with a card program manager. Each of the panelists identified Community Financial Resources (CFR)⁷ as his or her organization’s program manager. While CFR proved to be a valuable technical advisor, the card program manager that CFR used for the prepaid card programs had larger ramifications. Perhaps as a reflection of an evolving and dynamic industry, the card program manager announced its exit from the prepaid market in 2007, citing losses on the calling card side of the company, which made the support of its financial services division unsustainable. As a result of the card program manager’s withdrawal from that segment of the market, the Center for Community Change and the SEIU, which had already distributed 400 cards and 384 cards, respectively, were forced to postpone further distribution of their prepaid cards until a new program manager was selected. CCCSDV, which was on the brink of launching its pilot program, opted instead to delay its launch.

⁷ CFR is a nonprofit organization based in California that works with community-based organizations to develop financial service programs to serve low-income constituencies.

Despite the significant setback, the panelists agreed that the incident provided many valuable lessons and, more important, encouraged them to think of the larger implications of selecting a new card program manager. For instance, Hasson considered whether a large vendor would provide more stability and security than a small one, since a large vendor would more likely be able to draw on a larger pool of operational resources. She also considered, as did other panelists, the importance of retaining ownership of client data, which is a challenge, since card program managers maintain and store data on cardholders' transaction activity. Hasson pointed out that by securing access to cardholder data, nonprofits can ensure that they retain as members the cardholders they recruited for the prepaid card program.

Smith agreed with Hasson's assessment and noted that the SEIU created a user interface to capture member data before the data were submitted to the card program manager. However, the SEIU is still grappling with aggregating and interpreting the data. Smith suggested that organizations learn beforehand the type and the amount of data that can be obtained from the card program manager. Also, the amount of data that can be collected will be critical in determining how much an organization can learn from a pilot project.

Smith then turned to the types of challenges that organizations, especially nonprofits, may experience when implementing prepaid card programs. First, he emphasized that an organization's established infrastructure – or the extent to which it can be converted to meet new demands – can contribute to the success or failure of a new program. Smith acknowledged that the use of the SEIU's distribution network, which is based on direct mail and was established for the purposes of communicating with and organizing members, was not very conducive to the distribution of prepaid cards, since distribution generally requires face-to-face contact. Smith also noted the challenges of retooling the skills or expertise of an organization's staff to meet the needs of a new program. He pointed out that the SEIU's organizing expertise did not necessarily translate into the sales and marketing skills required for a prepaid card program. In addition to attaining new skills, existing staff take on increased responsibility and workloads.

Doan agreed with Smith's assessment, adding that the decision to incorporate an educational component into the center's prepaid card program did take some time, since the center's staff needed time to test the product and learn how it worked before it was more widely distributed.

Smith also cautioned against attempting to accomplish too much at the beginning of the program. He noted that in two newly organized locations, the SEIU, in addition to allowing members to participate in the prepaid card program, provided participants with its whole suite of services, including health-care and pharmacy discount benefits and an opportunity to participate in the earned income tax program. Consequently, disentangling the causes of a program's success or failure proved to be challenging.

In some cases, however, an organization's established infrastructure may support a new program. Hasson observed that the services that CCCSDV has provided over the decades — in particular, its debt management plan — prepared CCCSDV for the accounting demands of a prepaid card program. She noted that CCCSDV staff was accustomed to receiving payments from customers and making payments to credit card companies and ultimately reconciling accounts. This experience helped smooth staff members' transition to processing payments associated with prepaid cards.

Throughout their presentations, the panelists described their members' affinity for their organizations as the glue holding the program together. Doan referred to this affinity as the "keystone" of the program, which enables organizations to build on the relationship with their members to accomplish the project's goals. For nonprofits that aim to provide value to their members, education and knowledge concerning the use of a prepaid card — including an awareness of financial behaviors that maximize the benefits of having the card while minimizing actions that can trigger costly fees — are extremely important and can mean the difference between a product that promotes financial stability or one that erodes it.

The panelists concluded their presentations by reflecting on the insights obtained from offering a

prepaid program. Like Rhine, the panelists indicated that prepaid cards offer some of the positive attributes associated with checking accounts. Sharing anecdotal evidence collected from site visits, Doan pointed out that using prepaid cards affords cardholders a level of security and safety over carrying cash, which is a normal occurrence for some who visit the local check casher after each payday. Having funds loaded onto a card makes a cardholder feel less vulnerable to muggings and eases their anxiety of losing a sizable amount of money at one time. Pilot program participants also indicated that prepaid cards gave them access to a larger marketplace, such as online shopping. Others cited additional card features, such as the ability to transfer money between cards.

In considering the broader question of whether prepaid cards are adequate substitutes for checking accounts, Doan observed that prepaid cards can still be a costly proposition for cardholders, especially those without direct deposit. In such cases, cardholders cannot circumvent check-cashing fees and can incur cash-loading fees when depositing funds onto the card. The panelists also identified a number of infrastructure issues, such as the problem that might arise when an authorization hold is placed on the card. An authorization hold locks up some of the funds on the card. Consequently, when a person goes to use the card, the card may be denied because the amount of the payment is too large for the amount remaining on the card after accounting for the amount held.

Discussion

Touching upon Rhine's question about whether prepaid cards and checking accounts are product substitutes, many conference participants expressed concern about the cost of using prepaid cards and issues surrounding the convenience of reloading them. In particular, they expressed concern over the high fees that can be incurred during the normal course of using the card and the fact that loading funds or checking monthly balances on some cards is not very convenient for users. The speakers acknowledged that triggering any number of fees associated with the card — monthly fees, ATM fees, point-of-sale (POS) fees, or loading fees — can be costly. However, they stressed that the key is for an organization to negotiate a good contract

in order to offer a card with the lowest possible fees. The card offered by the organizations represented on the panel, for example, features a low monthly fee, \$1 or \$1.50 for ATM fees, and no POS fees. In addition, the speakers emphasized the importance of the educational component tied to the card as being the key to understanding the most cost-effective way of using the card. The speakers also acknowledged that reloading the card can be an issue, since it can be both time consuming and costly, averaging roughly \$4 to \$5 per load. Furthermore, the panelists pointed out that reloadings cannot occur just anywhere. Normally, cardholders can reload at sites operated by their partner merchants. There are also other reload networks, such as the Green Dot network, which includes several large retailers such as Walmart, Rite-Aid, CVS, and Radio Shack, among others. Moreover, MasterCard and Visa are developing their own reload networks composed of different merchants. Hasson and Doan also noted that their organizations have set up loading centers at their offices' sites in order to provide their customers with more convenience.

Cardholders have several options when it comes to checking their balances. Generally, cardholders can check their statements online for free or choose to receive a monthly paper statement for a fee. Additionally, some cards offer an 800 number that cardholders can call to check their balance. Still others offer a text feature (usually about \$1 a month) that sends daily text messages to cardholders' cell phones with the most recent balance information. This text-messaging feature, however, can be activated only for cell phones that have text-messaging capability, which involves an added cost. Some load sites, including those associated with the center, are making computers available to cardholders so that they can check their balances, in an effort to overcome any barriers to information technology accessibility.

Audience members also asked for clarification on the roles and responsibilities of each party in the nonprofit and vendor relationship and the potential to receive fee income to offset the costs of offering a prepaid program. The panelists agreed that a nonprofit's responsibilities include marketing the product, registering applicants, and obtaining documents to verify identity, as well as providing front-line customer

service, such as instructing consumers on how to use the card and manage their account. For locations that opt to be load sites, a nonprofit's staff also performs the loading and reconciling of accounts. The vendor's responsibilities include approving the application, mailing the cards to consumers, managing the account, and running the customer service hotline. Panelists pointed out that revenue opportunities are built in throughout the program, and locations that are load sites also receive a small share of the loading fee. The panelists also agreed that fee income can offset program costs once a certain scale of card adoption is reached, but they cautioned against underestimating the amount of work needed to run such a program.

Conference attendees also voiced concerns about certain consumer protections, such as whether prepaid card accounts are FDIC insured and whether cardholders are protected from overdrawing their account. The panelists noted that the program's pooled account — the overarching account comprising funds from cardholders' individual subaccounts — is FDIC insured, and therefore, the individual subaccounts are considered "deposits" and hence covered by FDIC insurance. In terms of overdrawing accounts, Doan explained that if the card is used to make a "live" transaction, the cardholder's balance will always be checked, and regardless of whether the transaction is approved or declined, the account will not be overdrawn. However, cardholders could potentially overdraw their accounts if purchases are made during off-line transactions, which usually occurs when cardholders sign for goods and services and these transactions are not settled until a later time (such as at the end of the day).

Some members of the audience were not as convinced of the value offered by prepaid cards and wondered whether it would be more prudent to move consumers toward more traditional banking services, such as a checking account or a savings account with a card feature. Others voiced concerns that prepaid cards prevented cardholders from building a credit history that could facilitate their move into more sophisticated products, such as mortgages and other asset-building vehicles.

The panelists generally agreed that offering consumers checking accounts would be preferable, but many circumstances preclude some consumers from establishing traditional banking relationships. They mentioned the stringent document requirements, negative sentiments about banks, or prior negative experiences with checking accounts, to name a few. Instead, prepaid cards should be regarded as a tool to fill some of the immediate financial needs. For some, prepaid cards can be a stepping stone to more traditional services. For others, who are unable or prefer not to move to a banking product, prepaid cards can continue as a financial product that can simulate some of the features of a checking account. Furthermore, where possible, the unbanked should be encouraged to develop relationships with banks and credit unions in order to take advantage of the low-cost checking accounts offered by the institutions; however, financial products such as prepaid cards should continue to be an option for consumers. In addressing the credit-building feature of prepaid cards, Doan noted that under a new pilot program, the center is offering an alternative credit-building feature that connects a cardholder's bill-paying history to an alternative credit-building report.

Finally, members of the audience inquired about the major challenge in offering a prepaid card program. In response, the panelists identified a mix of marketing concerns and the card distribution process as posing significant challenges to widespread card adoption. The panelists also pointed to the difficulties facing a nonprofit in its endeavor to distinguish its product with a limited budget while competing with large distributors such as Walmart, in a market where a large number of industry players are offering prepaid cards — all with different features and fee structures. The panelists also noted that retaining consumers throughout the card-adoption process can also be an issue. As Smith noted, to the extent that applicants have to take extra steps in order to complete the application process — fill out an application, provide or send in identification, and sign up for direct deposit — organizations and distributors will experience a drop-off at each step of the way. He suggested that organizations can limit the amount of drop-off by streamlining the application process.

IV. Innovation in Consumer Credit: Alternatives to Payday Lending

Jennifer Tescher served as moderator for the second panel. The speakers for this panel were Jim Blaine, of the State Employees' Credit Union of North Carolina; James Gutierrez, of Progress Financial; and Keith Welks, of the Pennsylvania Treasury Department. In her opening remarks, Tescher set the context for the panelists' discussion. She cited a dramatic growth in the payday lending industry that has triggered legislative and regulatory actions, at both the national and the state levels, to protect consumers against what are considered to be unfair, poorly structured high-cost loans. While Tescher considered the cost or APR of payday loans troublesome, what she deemed more problematic was the structure of loans that require repayment after two weeks, which trapped borrowers in a downward spiral of debt. As examples of the rising concern among many parties over this subject, Tescher pointed to reforms such as the amendment to the Defense Authorization Bill, effective October 2007, that capped interest rates on loans made to military personnel and their families, thus effectively eliminating the payday lending industry for that segment of the market, and the guidance issued by the FDIC on how to structure and price small-value credit. According to Tescher, the discussion surrounding the payday lending debate has increasingly led policymakers and industry representatives to ask: What is the right price? Can we do it affordably? Can we do it profitably?

Panel Presentations

During their presentations, the panelists touched on the questions above and also revealed their motivations for entering the payday lending market. In addition, they described the short-term lending products that their organizations created to function as alternatives to higher cost payday loans.

Jim Blaine, of the State Employees' Credit Union of North Carolina (SECU), argued that payday lending can be reasonably priced and profitable and can offer an opportunity to promote savings and asset-building. After witnessing a local payday lender arrive at the SECU every payday morning to deposit roughly 400

checks, Blaine began wondering just how many of his members were taking out payday loans. A subsequent survey of the SECU's membership revealed that at least 4,000 of its members were using payday lenders.

Blaine responded by creating the salary advance loan, a short-term alternative loan product, which, he noted, did not necessarily have to be high-priced to be effective. SECU's salary advance loan provides borrowers a maximum loan amount of \$500, at a term of 31 days, and can be renewed monthly. The cost of the loan is 12 percent, or an APR of 1 percent per month. Blaine also outlined the requirements for participating in the program: membership in the SECU, a checking account, and direct deposit. Borrowers also have to satisfy one underwriting criteria: they cannot be in bankruptcy, as demonstrated by their credit report.

Throughout his presentation, Blaine emphasized the profitability of his credit union's program, noting in particular the program's low default rate, which is estimated to be one-quarter of 1 percent at the SECU. Blaine observed that the low default rate debunks the notion that the underbanked segment poses a significant repayment risk. On the contrary, Blaine contends that the low default rate reflects borrowers' interest in protecting and ensuring their limited avenues to credit. Given the combination of growing revenues, low cost of funds, and low operating costs, Blaine stressed that an alternative loan product can be a significant source of profit for the organization.

According to Blaine, the incredible success and widespread adoption of the product in North Carolina presented an opportunity not just to offer a cheaper alternative to payday lenders but also to serve as an impetus to savings and asset-building in the state. As a result, the SECU added a mandatory savings program to the payday lending product, requiring that 5 percent of a borrower's loan amount be deposited into a pledged savings account at the credit union. To date, the SECU has over \$15 million in savings deposited by borrowers using their salary advance loan product, with some individual borrowers saving as much as \$2,500 — borrowers, Blaine contended, who never had savings before.

Blaine concluded his presentation by quantifying the cost savings accruing to borrowers annually. Estimating the difference between the amounts they would have paid if they had used a payday lender versus his product, Blaine pointed out that the 50,000 members using his product have saved over \$3.5 million a month in fees and interest, or \$42 million a year. As he aptly pointed out, that is \$42 million that “they can put back in their community, help educate their kids, buy cars, or buy a home.”

James Gutierrez, of Progress Financial, stated that his organization was established to meet the credit needs of Hispanic borrowers (including hard-working immigrants), with the goal of structuring a product that could help borrowers with short-term lending needs, despite their lack of credit histories. He agreed with Blaine that short-term consumer loan products can be made available at a lower cost than loans from payday lenders or credit card companies. However, as a newly established consumer finance company with a higher cost of funds, Progress Financial continues to work to make its unsecured lending program profitable.

Progress Financial’s primary product is an unsecured, amortizing personal loan ranging from \$500 to \$5,000, with an APR of 26 percent and a 5 percent origination fee. Progress Financial requires three items to process the application: an ID, a pay stub, and proof of address.

According to Gutierrez, the key to marketing to the Hispanic population is physically locating loan centers in areas where customers conduct their daily transactions. In the case of Progress Financial,⁸ the desired location is in ethnic supermarkets, next to other vendors such as insurance, cell phone, and check-cashing companies. Gutierrez also indicated that other helpful marketing strategies include advertising in Spanish, as well as advertising the ability to help borrowers build the credit histories necessary to access credit from mainstream financial institutions.

⁸ Currently, Progress Financial has 15 loan centers in large supermarkets in California.

Gutierrez also stressed the importance of building relationships with clients and understanding their financial needs and preferences, both of which serve to mitigate repayment risk. He maintained that ongoing client relationships are instrumental in keeping loan losses at a low level at Progress Financial, which are currently similar to prime credit card losses — 4 to 6 percent. Gutierrez further noted that understanding this segment’s preference for check cashers — despite the fact that roughly 70 percent of Progress Financial’s customers are banked — and its preference for conducting financial transactions at one place can be a useful risk management tool. For Progress Financial, locating in supermarkets where a check cashier is an anchor financial institution increases the organization’s chances of being repaid.

Drawing on Tescher’s introductory comments on the wave of legislative actions on payday lending occurring at the state level, Keith Welks, of the Pennsylvania Treasury Department, described the creation of a payday lending alternative in Pennsylvania, which stemmed from the legislative battles over the regulation of payday lenders in the state.

He recounted that once the General Assembly attempted to grapple with the topic of payday lending, the debate resulted in an impasse between members on one side who advocated for regulation and members on the other side who advocated an outright ban of the practice. All the while, Welks observed, the industry continued to operate legally in Pennsylvania, subject only to the regulations enforced by the Pennsylvania Department of Banking and those at the federal level. As a consequence, the Pennsylvania Treasury Department seized the opportunity to alleviate the growing payday lending problem in the state by partnering with the Credit Union Association of Pennsylvania (CUAP) to create the Better Choice Program, a loan program that could satisfy borrowers’ demand for a short-term lending product without the high fees and short repayment term characteristic of payday loans. In Welks’s opinion, “There is nothing intrinsically satanic about borrowing small amounts of money for short periods of time”; rather it is the practices associated with payday lending that are deplorable. In particular, Welks pointed to the structure of the payday loan: the requirement to repay in a lump sum the loan amount

in two weeks. This structure, by its very nature, causes the debt trap that policymakers often deplore, since borrowers cannot be expected to hand over an entire paycheck to repay a loan and conduct their normal monthly transactions without incurring additional debt.

The Better Choice Program takes into consideration this structural problem by increasing the term of the loan. The Better Choice Program offers a short-term installment loan that provides borrowers a maximum loan amount of \$500 that is to be repaid in 90 days, with the option to pay in installments. The cost of the loan is a flat fee of \$25. Borrowers participating in this program can take out only one loan at a time.

In addition to providing financial counseling, the Better Choice Program also features a savings component, which places 10 percent of the loan amount into a savings account at a credit union. In contrast to the SECU's program, the Better Choice Program includes the 10 percent savings in the amount to be repaid along with the loan amount requested, so that a consumer can borrow \$500 and have \$50 deposited into a savings account. In this example, the consumer, in essence, borrows \$550, but interest is not accrued on the additional \$50. Borrowers can elect to use the amount accrued in their savings account to make the last payment on their loan or to keep the amount in their account as a basis for savings.

The Treasury's partnership with the CUAP affords it access to CUAP's wide distribution network of branches across the state. Welks emphasized that this important feature allows the product to compete with local payday lenders, since borrowers frequently stressed the importance of convenience. He pointed out that many borrowers have acknowledged that payday lenders might appear to be a more costly alternative, but when they factor in travel costs and time to reach a more reasonably priced lender, payday lenders might seem like the better option. Welks concluded his remarks by reporting that, as of this conference, 57 credit unions were participating in the Better Choice Program, with a total of 167 branches across the state. He further added that 1,600 loans had been originated, with an estimated \$800,000 in savings for the borrowers.

Discussion

During the discussion session that followed, the panelists fielded several questions from Tescher and the audience. Questions included: What is an effective mix of price and term of loan for alternative lending products? How do organizations manage risk? How do organizations view product graduation? Why don't mainstream financial institutions offer more alternative products?

In dealing with the issue of price and the term of the loan, Tescher noted that each of the organizations represented on the panel offers products with differing APRs and repayment terms, as outlined in the panelists' remarks. When pressed to explain how these organizations arrive at the price and term of a loan, the panelists revealed that their organizations' product attributes largely mimicked product features or financial practices that their market segment had come to expect. For example, Gutierrez explained that his pricing and loan term reflects the type of financing found in Latin America, where customers are accustomed to installment credit and place great importance on a payment amount that they can memorize, remains fixed, and fits into their budget. Thus, they focus on the product's monthly payment. So, for example, a \$900 refrigerator will be advertised as costing \$100 a month for nine months. Consequently, the payment for Progress Financial's product is structured in accordance with the customer's weekly or bi-weekly paycheck.

Moreover, the organizations modified features in their alternative products to change behavior and to produce a more affordable and effective product. In Blaine's opinion, an alternative lending product that is expected to compete with payday loans has to have a term of 31 days. He pointed out that if organizations hope to change consumers' behavior, any new product has to mimic the product it is competing with, especially if borrowers are already used to the existing product's repayment terms. Additionally, Blaine thought that although borrowers can repay at more frequent intervals, setting the product up as a single-payment product meets certain Federal Reserve requirements and enables the organization to incorporate a mandatory savings feature into the

program. This, Blaine noted, is what separates the product from other lending programs. From Welks's perspective, the problem with payday loans is the short repayment term (i.e., two weeks) and the high repayment amount (i.e., the full loan amount). As a result, the Better Choice Program offers a repayment term of 90 days, which extends the term of the loan and thereby reduces the monthly payment to a more manageable figure. In the end, however, the pricing and term of the product is a function of cost considerations and whether such a program can be sustainable.

Tescher also encouraged the panelists to discuss the program features their organizations have adopted to minimize exposure to risk. Blaine pointed to the mandatory savings feature in place at the SECU, which serves not only as a basis for asset-building for the credit union's borrowers but also as a risk management tool.

He revealed that since his product is a single-payment product that is renewable every month, the credit union's risk diminishes each time it makes an advance. He pointed out that for repeat borrowers, the SECU would be half secured in six months and fully secured in 12 months.

Welks noted that the credit unions participating in the Better Choice Program can mitigate their losses stemming from risk by relying on a risk-sharing arrangement in the form of a loan-loss reserve pool. The loan-loss reserve — set up by the PCUA — leverages a deposit from the Pennsylvania Treasury Department at the PCUA's corporate credit union. The margin that exceeds the market rate of return on the deposit is used to capitalize the loan-loss reserve. Participating credit unions can apply to the loan-loss reserve for up to 50 percent of their losses, subject to the balance of funds in the pool.

In contrast, Progress Financial's risk management begins at the front end with the creation of a risk score, which is akin to a FICO score for its patrons. The risk score is based on 120 variables collected during the application process. In addition to demographic information, the risk score also includes the following influences: the family values of the applicant, regarded as "moral collateral"; the applicant's propensity to relocate to another state or

country of origin, i.e., "flight risk"; and the applicant's income-to-debt ratio, or "ability to pay." In addition, Progress Financial relies on references to verify the information submitted by its prospective borrowers. Finally, Gutierrez observed that early intervention when servicing loans, such as calling customers when they are one to two days past due, helps to lower losses.

One member of the audience asked if the panelists reported the payment behavior of their customers to the major credit bureaus and if they used information from the credit bureaus in their decision-making process. Both Blaine and Gutierrez indicated that reporting their customers' payment behavior to the credit bureaus is standard practice. Blaine reported that his organization also uses credit bureau information in assessing an applicant's loan request. However, Gutierrez pointed out that the majority of his organization's clients have thin files or no files, which makes it difficult to base a loan decision on credit bureau information.

Another attendee inquired whether the panelists have seen a subsequent increase in the number of credit card offers their customers receive and accept. Gutierrez noted that a small number of his customers have graduated to other credit products, while the majority — roughly 90 percent — return to Progress Financial to meet their short-term credit needs. He attributed the high retention rate to the strong client relationship cultivated by Progress Financial. Moreover, Gutierrez noted that many customers turn to Progress Financial for advice in assessing the true cost and terms of credit associated with the credit card solicitations they receive. Blaine added that if his customers graduate to a reasonable credit card, he would view that as success.

Some audience members inquired about the reasons that prevented credit unions and banks from more widely offering alternative short-term credit products. In the case of credit unions in Pennsylvania, Welks responded that an alternative payday lending program may not fit well into banks' and credit unions' business models. He pointed out that some credit unions are one-branch operations and operate largely through electronic transactions. Therefore, they lack the distribution network conducive to offering either an

alternative product or the financial credit counseling that normally accompanies it. Welks also indicated that the small size of some credit unions prevented them from undertaking the risks associated with alternative products.

A follow-up question asked whether mainstream products such as overdraft protection deterred the adoption of alternative programs. According to Blaine, products such as bounce protection and delinquency overdraft are deterrents to alternative lending programs, since the high fees associated with these products generate revenue for financial institutions. In Blaine's opinion, these products should be regulated under Truth in Lending, which would cap the fees that could be charged for these products and pave the way for true lower-cost alternatives. Gutierrez added that regulators tend to support seemingly contradictory aims by, on the one hand, encouraging financial institutions to adopt innovative programs to serve underserved consumers, and, on the other hand, holding them to strict standards to protect their deposit base and assets. Several bankers in the audience agreed with this assessment, adding that their banks offer some alternative lending products but regulations often prevent their institutions from offering products with flexible features that could truly help consumers. Other bankers said that their main strategy is to modify traditional bank products, such as offering smaller lines of credit. They said that this strategy is in keeping with Federal Deposit Insurance Corporation (FDIC) chair Sheila Bair's recommendation to use existing systems to serve consumers in a more affordable and profitable manner.

V. Alternative Credit Data: Reaching Untapped Markets

Moderator Patrick Walker, of the Political and Economic Research Council (PERC), introduced the speakers on the third panel: Michael Nathans, of Pay Rent, Build Credit, Inc. (PRBC), and Vikki Frank, of the Credit Builders Alliance (CBA). In this session, panelists discussed the potential impact of using alternative credit data to augment the credit histories of thin-file or no-file consumers in order to bring them into the financial mainstream. Panelists also discussed

how lenders can take advantage of alternative credit data as another source of payment information that can enable them to conduct better risk assessments on their consumers and potentially increase their market share. Walker began the discussion by exploring the viability of using alternative data and the value that alternative credit data can provide to both borrowers and lenders if used more broadly in the industry. Following his presentation, panelists Nathans and Frank described the particular ways in which their organizations work with borrowers and lenders to report and access alternative credit data in order to move more consumers into the financial mainstream.

Walker framed the discussion for this panel by drawing on some of the research on alternative data his organization has conducted.⁹ According to Walker, alternative credit data refers to positive payment information not traditionally reported to the three major credit reporting agencies, including payments for rent and other services such as energy, telecom, water, and cable. Walker further observed that the value of positive payment information (as opposed to negative payment information, which may already be reported for consumers with very late payments) is contingent on how practical and effective it is to report the data. For example, he noted that energy and telecom payments were good sources of alternative credit data because they satisfied three important dimensions. Energy and telecom data are considered *more credit-like than cash-like*, since the act of reporting the data would likely influence payment behavior by rewarding consumers for timely payments and penalizing them for late payments; have a *wide coverage* among consumers, which translates into more augmented credit files; and are *concentrated among a few companies*, which makes it more likely that the payment information will be reported in a timely and consistent manner. To highlight the importance of "concentrations," Walker pointed to the rental industry as an example of a data type that would be a good source of consumer payment history but one that might pose challenges in terms of

⁹ The research is from PERC's Alternative Data Initiative, which benefits from the involvement of the CFSI, the Brookings Institution, and many other organizations.

the information being reported to credit bureaus. He explained that because of the fragmented nature of the rental market, the sheer number of landlords makes it difficult to enforce the timely and consistent reporting of rental payments.

Walker reiterated the importance of a credit history in navigating the financial mainstream and building assets. He noted that this is critical for individuals who use their personal credit history to finance or support a small business. According to Walker, the impact of alternative credit data on small businesses is often neglected.

In assessing the “lift” that alternative credit data might provide to credit bureaus, lenders, or borrowers, Walker shared the results of an analysis conducted under PERC’s alternative data initiative. The analysis was based on a data sample¹⁰ of credit files from TransUnion¹¹ that consisted of at least one energy and one telecom payment. The results suggested that the inclusion of certain alternative credit data would produce “actionable” credit scores for consumers that previously had a thin file — a disproportionate number of whom were lower-income and minority consumers. Walker noted, for example, that without the energy and telecom payment information, 15 percent of their sample of African-Americans and 22 percent of Hispanics would have been unscorable.

Walker further observed that when previously unscorable consumers obtain credit scores as a result of additional payment information, the resulting range of scores mirrors the distribution of credit scores of the general population, except for the super prime (consumers with credit scores in the top 10th or 15th percentiles). In other words, consumers with thin files would not necessarily receive low credit scores when additional payment information is introduced. This, Walker said, is a point that serves as a reminder that

¹⁰The number of credit files in the sample that contained at least one telecom payment and information on one energy payment was 8 million, or 4 percent of all credit files at TransUnion.

¹¹TransUnion is one of the three major credit reporting bureaus; the other two are Equifax and Experian.

consumers with no credit or not enough credit are not necessarily a credit risk.

Walker also emphasized the potential for increased lending that might occur with the use of these types of alternative data. He explained that after augmenting the files of consumers in the sample with utility and telecom data, a target default rate of 3 percent was applied to the sample to determine if any of the individuals would be considered creditworthy. The analysis estimated that lenders could increase their market share by as much as 10 percent, given the added data. The beneficiaries would disproportionately be minorities and low-income consumers more than other groups. This is due to two types of effects. One is a “new entrant” effect, or a widening of the consumer lending pool to include those who were previously overlooked because of a lack of adequate payment information in their file. The other is a “resorting effect,” or the increased ability of lenders to distinguish those consumers deemed a good risk from those considered a bad risk. On a final note, Walker pointed out that the addition of alternative credit data in a person’s credit file can enable an individual to build credit using standard monthly payments, without necessarily accumulating debt in the form of a loan or credit card.

Panel Presentations

Michael Nathans, of Pay Rent, Build Credit, Inc. (PRBC), also believes that the reporting of alternative credit data to credit bureaus can enable consumers to build the credit necessary to enter the financial mainstream and move onto the path to asset-building. PRBC is a credit bureau like Equifax, Experian, and TransUnion and thus has the same obligation to treat consumers’ information confidentially and release it only to appropriate parties. But PRBC relies on various types of alternative bill-payment data. As described by Nathans, PRBC automates processes that are either encouraged under the Community Reinvestment Act (CRA) or required under the Equal Credit Opportunity Act (ECOA). Under the CRA, a financial institution can receive credit for providing a community development service to its deposit customers when it helps them build a credit history by reporting bill payments that otherwise may not get reported to a credit bureau. Under section

202.6 of ECOA, when a credit report is pulled to assess the credit risk of a consumer, lenders may consider any of the consumer's other bills, including payment information not traditionally reported to the credit bureaus, as long as the consumer requests it. As a credit bureau that is compliant with the Fair Credit Reporting Act (FCRA) and one that incorporates alternative credit data, PRBC facilitates the reporting and accessing of the types of alternative credit data that may be used under the CRA or the ECOA.

According to Nathans, PRBC is the only credit bureau that allows consumers to build their own credit report by reporting positive bill-payment information such as payments for rent, utility, cable, or phone. Consumers can access the reporting feature by logging on to PRBC's website and signing up for a bill-payment service that will update their files on a monthly basis. Nathans added that consumers can develop a payment history by retroactively reporting payment information from the last three years. In response to concerns about the objectivity of having consumers report their own payment information, Nathans emphasized that all payment information submitted to PRBC is aggregated and verified by a trusted third party and conforms to verification procedures that meet and exceed Fannie Mae, Freddie Mac, and FHA standards.

Echoing Walker's comments concerning "lift," Nathans pointed out that lenders can access PRBC's data. Thus, the type of service offered by PRBC, which is to provide electronic access to the credit histories of consumers who may otherwise be considered thin file or no file at other credit bureaus, can assist lenders in assessing the risk associated with a potential borrower.

Nathans also stressed the importance of attaching value to alternative credit data by enabling users to efficiently and effectively employ the data. To that end, PRBC has developed (in conjunction with Fair Isaac) a product called "PRBC Reports with FICO Expansion Score,"¹² which enables PRBC's system and

¹² For a description and discussion of the FICO Expansion Score, see "Recent Developments in Credit Scoring: A Summary," Federal Reserve Bank of Philadelphia, www.philadelphiafed.org.

the data in its database to interface with the automated underwriting used by lenders.

Nathans also indicated that PRBC has undertaken a number of initiatives to expand its credit reporting service, including a partnership with CheckFree, an organization that powers the online bill-payment services for many banks and credit unions, and a check-cashing initiative to report the payment activity of underbanked consumers.

Vikki Frank, of the Credit Builders Alliance (CBA), maintains that for underserved consumers to build their credit files, their payment information must be reported to the major credit bureaus in a manner consistent with the other reports of credit payments obtained from creditors in the financial mainstream, including payment information on small-value loans taken from community lenders or microfinance institutions. Frank further noted that these latter lenders — which include nonprofit organizations, community lenders, and community asset-building organizations — individually make anywhere from 10 loans to 400 loans a year, yet their lending activity still proved too low to report their borrowers' repayment information to the major credit bureaus.

To overcome this reporting challenge, the CBA met with representatives from the credit bureaus and community lenders to understand the respective challenges they face. According to Frank, one main hurdle was that the credit bureaus recently required all data reporters to report their data electronically, which improved the speed and accuracy of the reporting process. However, this change in the reporting format made it difficult for community lenders who still relied on reporting manually or by fax. Community lenders' small size made it hard to justify investing in the technology and infrastructure for electronic reporting. Another hurdle was that community lenders often required additional technical assistance that ranged from how to code and report specific delinquent behavior to providing credit reporting training for their staff. Frequent staff turnover made this more burdensome. Credit bureau staffs, on the other hand, were busy managing the monthly processing of payment information associated with 250 million credit files, leaving little time to field questions from small

reporters. In addition to the reporting challenges, Frank also noted that the small files of payment information from community lenders made it difficult for the credit bureaus to electronically analyze the data for fraudulent or suspicious behavior, a necessary process before the data are posted on consumers' credit files.

Frank explained how the CBA serves as an intermediary between community lenders and the three major bureaus to address the difficulties lenders encounter in reporting their clients' payment information. She noted that the CBA pools the repayment information reported by small community lenders and then submits an aggregated file to the credit bureaus. The CBA also provides technical assistance and credit reporting training to the staffs of community lenders and other nonprofit organizations. Since the launch in May 2007 with Experian, the CBA has 21 community lenders who have memberships with Experian, 13 of which are currently uploading 3,500 trade lines pertaining to loans made to the underserved in their communities.

Beyond collecting and aggregating alternative credit trade lines, the CBA also provides credit knowledge to its members as well as supporting members' efforts to provide credit and financial education to their clients. In this role, the CBA offers information that includes which data are contained in a credit report, updates on regulatory changes concerning credit reporting, and how to apply for and obtain HUD certification in order to pull credit reports on behalf of their clients. More broadly, Frank reported that the CBA is making research plans to explore the ramifications of a credit score as a financial asset. Of particular interest is how much the addition of alternative credit trade lines can improve a person's credit score. Furthermore, how much does the improved score translate into savings through lower interest rates and fees over a borrower's lifetime? The CBA is also experimenting with small credit-builder loans to assess their efficacy in boosting a consumer's credit report. More specifically, the CBA is interested in how much small, structured credit products can affect a consumer's credit score compared with larger credit products such as mortgages.

Discussion

The discussion of the panelists' remarks centered largely on the nature of the demand for alternative data in mainstream credit markets, with a specific focus on how receptive lenders are to using alternative data, how easily lenders can incorporate them in their credit decisions, and how well the data predict consumer repayment behavior.

Audience members wondered how the sub-prime crisis has affected the demand for alternative credit data. More specifically, attendees questioned whether recent events in the mortgage market have caused lenders to become more cautious and reluctant to incorporate a relatively new and nontraditional source of information in their credit risk models. Nathans argued that using alternative data does not necessarily mean diverging from traditional credit risk assessment, but rather it can bring lenders back to basics when evaluating an applicant's creditworthiness. Echoing a point made earlier, he cautioned against equating no-file or thin-file consumers with consumers with bad credit, since, by definition, no-file or thin-file consumers are individuals with inadequate credit (and possibly no bad credit). He noted that an estimated 35 to 50 million people do not have the required four trade lines on a credit report to receive a traditional credit score. Consequently, they are unable to qualify for a mortgage or other types of credit. With alternative credit data, borrowers who were otherwise outside the mainstream credit markets can demonstrate their actual payment behavior, thus widening the pool of prospective borrowers for lenders.

Underscoring Walker's point about the distribution of credit scores for borrowers who were traditionally no file or thin file being comparable to the general population, Nathans insisted that the payment behavior of many of these consumers (as reflected in alternative credit data) would make them eligible for prime loans, which can then be sold in the secondary market to Fannie Mae and Freddie Mac. In Nathan's view, a distinction has to be made between using alternative credit data to evaluate potential prime borrowers and using exotic loan features to qualify otherwise risky borrowers. Frank also remarked that lenders' interest in

alternative credit data has increased, especially since the recent foreclosure crisis has sharpened the focus on the activities of nonprofits and their ability to establish and maintain relationships with homeowners at risk of foreclosure.

Conference attendees also queried whether some lenders, including payday lenders, might refrain from reporting repayment behavior for fear that their consumers would graduate to other credit products, a result that might be detrimental to their business. While the panelists could not speak for the payday lending industry, Frank observed that the lenders who are part of the CBA generally embrace the reporting of alternative credit information, not only because it promises to build their clients' portfolios but also because it bodes well for the overall quality of the organizations' portfolios. But she also indicated that some lenders who have not traditionally reported payment behavior to the credit bureaus have come to realize that they are among the last creditors to be repaid, since clients know these creditors do not report their repayment patterns.

Finally, in an effort to better understand the underbanked segment, audience members were curious about the typical profile of consumers who use the services provided by PRBC as well as the community lenders associated with the CBA. Reinforcing Tescher's earlier comments, the panelists painted a diverse picture of their consumers. As might be expected, they include immigrants, refugees, and others with no files or thin files. They also include consumers whom one might not expect, such as credit scoreable individuals with blemished credit histories that prevent them from obtaining credit from lenders who report to the three major credit reporting bureaus. The panelists also described other consumer segments such as small-business owners looking to establish credit for their businesses, consumers with mortgages from private lenders that do not report payment behavior, and even consumers at mainstream financial institutions who regularly pay bills online but who have not used enough credit products for the credit bureaus to calculate a credit score for them.

VI. Closing: Insights from KeyBank's Approach

Michael Griffin, of KeyBank, concluded the day's conference by sharing his bank's approach to serving the underbanked. Griffin pointed out that at KeyBank, reaching out to the underbanked requires more than just offering products such as a free checking or savings account, a policy initially pursued by KeyBank that has yielded less than desirable results. He recounted that in an effort to create a profitable and sustainable program to serve the needs of the underbanked, KeyBank conducted a series of research projects to learn about the preferences and perceptions of this segment of the market. In conjunction with the CFSI and the Ford Foundation, KeyBank undertook research to gauge the size of the underbanked market and to evaluate and capitalize on the potential market opportunity. KeyBank also conducted focus groups to better understand how the underbanked perceived various financial services providers. The bank found that the underbanked regarded the banker as an impersonal character in a shirt and tie, while the check casher was someone with whom they could identify, usually a person from the neighborhood or even a family member. The focus groups also revealed the participants' perceptions that banks did not want them as clients.

Based on the findings of this research, KeyBank embarked on a targeted strategy that considers the underbanked's financial demands and their perceptions of certain financial services providers. In addition to overcoming the myths that the underbanked held about traditional financial institutions, Griffin stressed that it was also necessary to overcome the myths that bank personnel had about this segment of the market. This led KeyBank to undergo several changes, including changing the look and feel of its bank branches from conservative corporate colors to more inviting vibrant hues. KeyBank also built its strategy around a low-fee check-cashing service aimed at helping consumers overcome the hurdle of entering a bank. Besides providing a much needed service at a low cost — KeyBank's Plus program charges a 1 percent check-cashing fee, which is lower than the rate at the average local check

cashier — KeyBank hopes to use this service as a basis to move consumers to other products, such as checking accounts, savings accounts, remittance services, or bill payment. KeyBank's check-cashing consumers also have access to free money orders to pay bills and the opportunity to receive financial education.

The KeyBank Plus program has a presence in 121 of KeyBank's branches nationwide and has processed over 35,000 transactions with a dollar amount of \$24 million.¹³ KeyBank is also involved in other initiatives, such as sponsoring 14 earned income tax credit sites. With this initiative, KeyBank hopes to open checking accounts for consumers using these tax preparation sites, which will provide them with a lower-cost option for receiving their tax refunds and move them away from refund anticipation loans (RALs).

Griffin concluded his presentation and the day's proceedings by reflecting on the industry's progress in its efforts to serve the underbanked. He compared the efforts to an old mythical story of creation popular in Mexico, known as the *Popol*

¹³ In an update after the conference, Griffin reported that KeyBank has expanded service to a total of 210 branches and has cashed over \$78 million in checks.

Vuh. This fabled story of creation describes several unsuccessful attempts by the Heart-of-Sky (the creator) at creating humans, who, in turn, would offer praise to the maker. After several attempts went awry and were discarded, the creator conferred with the other gods (of earth and water) to pool their best ideas to form a better action plan.

According to Griffin, in much the same way, early products created to serve the underbanked — products designed largely on scant information and little understanding of this particular segment — have failed to adequately meet their financial needs and subsequently have faded away. The industry embarked on a second push, where some progress was made and even some products were created that might be considered substitutes for traditional banking products, yet they did not quite meet the demands of the underbanked. Griffin contends that the industry is on the cusp of a breakthrough, which can be precipitated by collaboration among key participants. He pointed to the cooperation among industry leaders, nonprofit organizations, and policymakers as evidence of the industry's progress. Griffin postulated that, collectively, these participants can capitalize on the lessons learned from the past and work toward a cohesive approach to create products that will not only satisfy the needs of the underbanked but ultimately take on lives of their own.

Conference Agenda

- 9:00 a.m. **Welcome**
Dede Myers, Federal Reserve Bank of Philadelphia
- 9:05 a.m. **Serving the Underbanked: State of the Industry**
Jennifer Tescher, Center for Financial Services Innovation
- 9:30 a.m. **Prepaid Cards: A Substitute for the Checking Account?**
Moderator: Sherrie Rhine, Office of the Comptroller of the Currency
Panelists: Tam Doan, Center for Community Change
Patricia Hasson, Consumer Credit Counseling Service of Delaware Valley
Jeremy Smith, Service Employees International Union
- 11:05 a.m. **Innovation in Consumer Credit: Alternatives to Payday Lending**
Moderator: Jennifer Tescher, Center for Financial Services Innovation
Panelists: Jim Blaine, State Employees' Credit Union of North Carolina
James Gutierrez, Progress Financial
Keith Welks, Pennsylvania Treasury Department
- 2:00 p.m. **Alternative Credit Data: Reaching Untapped Markets**

Moderator: Patrick Walker, Political and Economic Research Council
Panelists: Vikki Frank, Credit Builders Alliance
Michael Nathans, Pay Rent, Build Credit, Inc.
- 3:20 p.m. **Closing: Insights from KeyBank's Approach**
Michael Griffin, KeyBank
- 3:45 p.m. **Conference adjourns**

Institutions Represented at the Conference

Abundant Life Fellowship Church	National Economic Opportunity Fund
AccountNow	Nationalities Service Center
AdvanceMe Inc.	Nehemiah Gateway Community Development Corporation
Advanta Bank	New Jersey Citizen Action
American Credit Alliance, Inc.	New Kensington Community Development Corporation
American Street Financial Services Center	NYC Office of Financial Empowerment
Annie E. Casey Foundation	Office of the Comptroller of the Currency
Asian Bank	Open Hearth, Inc.
Beneficial Bank	Operation HOPE
Campaign for Working Families	Opportunity Finance Network
Center for Community Capital	Parkside Business & Community in Partnership, Inc.
CIC Financial Services	PathWaysPA
Citadel	Pay Rent, Build Credit Inc.
Citibank	Pennsylvania Credit Union Association
Commerce Bank	Pennsylvania Department of Banking
Community Bank Delaware	Pennsylvania Housing Finance Agency
Congreso de Latinos Unidos	Pennsylvania Treasury
Consulting for Change	Philadelphia Chinatown Development Corporation
Consumer Credit Counseling Service of Delaware Valley, Inc.	Philadelphia Corporation for Aging
Cramer Hill Community Development Corporation	Philadelphia Development Partnership
Credit Builders Alliance	PNC Bank
Delaware County Office of Housing and Community Development	PNC Bank, DE
Dignity Housing	Political and Economic Research Council
Federal Deposit Insurance Corporation	Progress Financial
Federal Reserve Bank of Philadelphia	Rising Tide Community Loan Fund
Federal Reserve Bank of St. Louis, Little Rock Branch	Rural Opportunities, Inc.
Federal Reserve Board	SCC Financial Solutions
Ford Foundation	Seedco
Franklin Mint Federal Credit Union	SEIU Health Care Access Trust
Freedom Credit Union	Shore Bank
Fulton Bank	SKS Microfinance Foundation
GE Money	Sovereign Bank
Guaranty Bank	State Employees' Credit Union of NC
HACE	Stevens & Lee
Hanover Fire & Casualty Insurance Company	Susquehanna Bank
House Appropriations Committee (D)	TruMark Financial Credit Union
HSBC TFS	U.S. Bank
Indian Head Financial Systems	U.S. Committee for Refugees and Immigrants
Indian Valley Housing Corporation	United Communities Southeast Philadelphia
Innovest Strategic Value Advisors	United Way of Southeastern Pennsylvania
IPP of America	University of Pennsylvania
Isles	Univest National Bank and Trust Company
KeyBank	URDC
KPMG Banking Insider	VALID Systems
M&T Bank	Wachovia
Montgomery County Community Action Development Commission	Wachovia Corporation
	Women's Opportunities Resource Center
	WSFS Bank