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Literature on the Unbanked

By: Mason Anderson, Ivan Huerta

Abstract

This paper summarizes a culmination of literature on the unbanked in the United States. The unbanked are individuals who do not have a bank account and are thus out of the financial mainstream. Characteristics such as: low income, non-white, younger, and less educated, are correlated with being unbanked. For this reason, most researchers believe that being unbanked is a problem and may be the result of financial illiteracy and a miscalculation of the high costs of being unbanked. Other researchers feel that the costs of being unbanked and using fringe banking services are often over estimated and being unbanked may be the optimal decision. This is the minority view in the field. Many unbanked individuals use check cashing outlets (CCO) and other fringe banking establishments such as "Payday" loans to complete transactions because they do not have access to regular banking services. These fringe banking practices often come at a high cost, sometimes as much as ten percent of the checks value. Unbanked individuals also have a harder time acquiring assets than individuals in the financial mainstream. Many solutions to this problem of financial exclusion have been suggested; such as financial literacy programs, increasing the number of banks in low income areas, and reduced cost banking also known as, lifeline banking. While the authors cannot state which of these solutions work, some policies, such as lifeline banking and financial literacy programs, seem to be more effective than others. Future research on the unbanked should examine whether this apparently poor financial decision is an optimal choice. Future research should also tease out the relationship between financial exclusion and poverty.

Introduction:

To build wealth it is necessary to have financial tools and a means of saving. For this reason in is essential to be in the financial mainstream. Financial exclusion is defined as an individual or household who has no formal bank account (Berry, 2004; Buckland, Dong, 2008; Hogarth et al, 2003, 2005). Buckland and Dong (2008) ask a pertinent question. "Does financial exclusion cause poverty, does poverty cause financial exclusion, or does some other deeper process cause them both?" We find that though poverty and financial exclusion are correlated, which of these mechanisms leads to the observed correlation remains unclear. However, understanding the correct answer is imperative for policy. Most research in the field concurs that being part of this "unbanked" population is a problem because individuals have no way to develop financial knowledge and accumulate assets (Buckland, Dong, 2003; Washington, 2006). Research suggests that financial inclusion leads to poverty alleviation.

There are many policies and financial innovations that could bring people into the financial mainstream: promoting financial education, lifeline banking, mobile banking and an increasing the number of banks in low income areas (Hogarth et al, 2003,2005; Washington, 2006; Buckland, Dong,2008; Burgess, Pande, 2005). While these solutions make theoretical sense, there continues to be debate on their effectiveness (Washington, 2006; Berry, 2004; Burgess, Pande, 2005; Lyons, Scherpf, 2004).

Demographics:

To understand the problem of being unbanked it is important to first discuss the demographics and potential risk factors of being unbanked. Being young, less educated, non-white, particularly blacks and hispanics. and a lower income are correlated with being unbanked (Berry, 2004; Washington, 2006; Hogarth et al, 2003; Rhine et al, 2013). Blacks were 12.7 percentage points and hispanic populations were 11.5 percentage points more likely than their white counterparts to be unbanked (Rhine, Greene, 2013). This could suggest that minority populations have less access to the banking system or are more financially illiterate than white populations. These results are concerning because being unbanked is correlated with having a low socioeconomic status and the majority of the unbanked population is made up of these minority populations.

Being unbanked is also responsible for lower asset accumulation (Rhine et al,2013). This problem can be found in the demographics as individuals who are unbanked are also more likely to rent rather than buy their own house (Berry, 2004; Rhine et al,2013). This is most likely caused by the limitations of asset accumulation (Washington, 2006).

The likelihood of being unbanked is affected by certain family characteristics as examined by Hogarth, Anguelov, and Lee (2003). Surprisingly, larger families have a higher probability of being unbanked (Hogarth et al, 2003). This is thought to

be caused by the additional expense of each child. This is an interesting correlation as one would expect larger families to have more financial needs and longer planning horizons, thus pulling them into the financial mainstream. Additionally, households that are headed by single females are more likely to be unbanked (Washington 2006; Hogarth et al, 2005). Both of the previous correlations suggest that financially strained individuals are more likely to be unbanked. This may be due to insufficient income keeping an individual out of the financial mainstream. Though more research is needed to further examine these findings (Hogarth et al, 2005). Future research should also focus on separating and distinguishing if these correlations are truly causing individuals to be unbanked or if there is a possible unseen third variable.

One of the speculative causes for being unbanked is financial illiteracy (Toussaint-Comeau, Rhine, 2007). Unsurprisingly, a lack of understanding of financial policy has been found to be correlated with being unbanked. Individuals who receive government aid such as the Temporary Assistance for Needy Families (TANF) or Food Stamps believe that having a bank account will affect their eligibility (Hogarth et al, 2005). Only thirteen percent of individuals receiving these aid packages knew what their asset accumulation limit was (Hogarth et al, 2001). The other eighty-seven percent were unable to correctly identify the level of savings one could have until their aid was impacted. Unbanked individuals who rely on these programs may fear that acquiring a bank account could cause them to lose their livelihood.

Causes of Financial Exclusion:

The causes of financial exclusion are explored and defined differently between papers. Most can be categorized in the ways Hogarth, Anguelov and Lee define them (2003). The four categories are product design, human capital, product motivation, and institutionalist constraints. Product design encompasses high minimum balance and high fees, as well as not writing enough checks as reasons for not having an account. Human capital is defined as "poor credit" or "can't manage account". Product motivation includes the reasons "lack of money" and a self reported "no need for a checking account". The key difference between product motivation and product design is that product motivation focuses on the demand side while product design is focused on the supply side. The final category is institutionalist constraints, which include "don't like dealing with banks" and no convenient hours or location.

Hogarth, Anguelov, and Lee (2005) find that the majority of unbanked individuals cite product design (47.6%), specifically the subset within product design, "don't write enough checks" (28%); and product motivation (18.6%), with the subset "don't have enough money"(17.6%) as their reasons for not being in the financial mainstream. Inaccessibility to banks is often theorized as the main reason many individuals are unbanked (Burges, Pande,

2005). An important finding from this study is that only one percent of individuals reported inconvenient bank locations and hours, these results are supported by Berry (2004).

The institutionalist constraints such as "don't like dealing with a bank" may come from immigrant populations(Lyons, Scherpf, 2004). Immigrants "may have attitudes and perceptions toward banks that are shaped by negative experiences in their country of origin"(Toussaint-Comeau, Rhine, 2000). This perception of banks and the mistrust of banks may also deal with the level of financial literacy one has (Lyons, Scherpf, 2004). Immigrants coming from underdeveloped countries may be unaware of the benefits of financial inclusion (Toussaint-Comeau, Rhine, 2000). There may also be language barriers or differences in culture that cause some immigrants to remain unbanked (Hogarth et al, 2003). This "don't like dealing with banks" response may also be a privacy preference that makes the individual nearly impossible to bring into the financial mainstream (Hogarth et al, 2003).

Many researchers also find that attachment to the labor force is a strong predictor for whether individuals are in the financial mainstream. The least likely group to have a transaction account were those "unemployed-looking for a job;" (Hogarth et al, 2005). This is a cause of financial exclusion as this group of people are likely to have much tighter budgets and thus maintaining a minimum balance does not allow them to utilize all of their savings necessarily. Thus these people would be categorized into the product design group.

Problems Associated with Being Unbanked:

There are problems with the check cashing outlets (CCO), also known as "payday loans", being financially harmful to the unbanked. Jean Ann Fox (2006) explains how CCOs are more likely to cash government checks than hand-written payroll checks. The Office of the Comptroller of the Currency (OCC) survey discovered that about "two out of five (42 percent) unbanked consumers used money orders to pay bills and the majority of them (67 percent) purchased their money orders at check cashing outlets. The OCC survey found that more than one in seven (15 percent) of unbanked consumers used bill payment services at check cashing outlets." (Fox, Woodfall, 2006) "The high cost of cashing checks at check cashing outlets exceeds the cost of processing the checks." (Fox, Woodfall, 2006) This implies that those 42% unbanked consumers that cash their checks at CCO's are charged at a high cost, which not only harms them financially, but . If an unbanked customer were to transition to banked, they could cash their checks for free at their local bank.

Scholars make the argument that being unbanked may not be a problem. Christopher Berry (2004) argues that unbanked individuals are not worse off using CCO. Unbanked individuals may not be uninformed about the cost of using

a CCO. In fact, banking individuals tend to overestimate the cost of cashing a check at a CCO. Berry also found that many unbanked individuals use supermarkets to cash their checks without any cost. Berry (2004) feels that unbanked individuals seem to be well informed about the costs of being unbanked and often report that they are satisfied using these fringe financial institutions. These results counter most research and views of the field.

Christopher Berry (2004) creates a table explaining reasons for cashing checks at banks and CCOs. When he asked unbanked consumers the question "Why do you prefer cashing checks at a CCO rather than Bank?", 49.2% of unbanked consumers chose "more convenient". That percentage is greater than 38%, which is the percentage of how many unbanked consumers answered "more convenient" when they were asked the question "Why do you prefer cashing checks at a banks rather than CCO". But when he asked the unbanked consumers where they prefer cashing their checks, "banks or CCOs or vice versa" based on costs, 50.5% of unbanked consumers prefer to cash their checks at banks rather than CCOs. That percent is higher than of the 18% of unbanked consumers who prefer to cash their checks at a CCO rather than at banks. This implies that unbanked consumers recognize that they are being charged more at CCOs than at banks, but feel that it is more convenient. These results indicate that their best option is to cash their check at a bank.

There are many other scholars that make the argument that being unbanked is a problem. Jeanne M. Hogarth (2003) explains that unbanked individuals don't have the knowledge and education needed to feel comfortable in a bank. "Basic budgeting and financial management education may be helpful in addressing these practical factors. Financial institution may want to collaborate with money management educators in working with customers or former customers who may have a tendency to overdraw their accounts." Individuals who are unbanked may have no idea how owning a checking or savings account functions, as well as how the fees are determined. This may cause individuals to remain unbanked.

Michael S. Barr (2002) explains that unbanked people are unable to make the minimum of a checking account when the bank includes high level charging. "Consumers who cannot meet account balance minimums for a checking account at a bank pay high monthly fees, and most banks also levy high charges for bounced checks that low-incomes with little or no savings face a high risk of paying and can ill-afford. Financial institutions may also charge high fees for money orders or other products that their typical customers do not often use." Unbanked individuals are unable to transition from unbanked to bank due to financial troubles keeping up with the minimum balance of a checking account. These fees and minimum balances are not exceptionally high; however, poverty and being unbanked are related. These fees may take up a much higher portion of an unbanked individuals income. The minimum balance also creates an opportunity cost problem, as

that minimum balance may need to be used instead of saved.

Barr (2002) also explains that the problems of being an unbanked individual is that some individuals have had negative experiences with banks. Barr explains that “Nearly seven million individuals are currently recorded as having had their accounts closed for prior problems, such as writing checks with insufficient funds or failing to pay overdraft charges, in the ChexSystem, a private clearinghouse used by most banks to decide whether to open bank accounts for potential customers. Records of prior problems are kept in the system for five years, during which time these individuals will be unable to open a conventional bank account at most banks, thrifts, and credit unions.” Some unbanked individuals have had serious issues in the past with banks that they are unable to go back and reopen their checking accounts.

Barr explains that a problem of being an unbanked individual is with accessing banking services in the low income areas, urban and rural communities, thrifts, etc. Barr explains that “A 1997 Federal Reserve Board study found that low-income central city neighborhoods have fewer bank offices per capita than higher-income areas and those outside the central city. Similar patterns may persist in the distribution of ATMs: In New York and Los Angeles, there are nearly twice as many ATMs per resident in middle-income zip codes as there are in low-income zip codes, according to 2000 Treasury Department research.” Unbanked individuals face a situation between the availability and access of bank services due to them living in low-income areas. Other studies find that unbanked individuals do not feel that this is a problem(Hogarth et al,2003; Berry, 2004).

The unbanked come across the problem of high interest rates. Ebonya Washington (2006) explains how unbanked individuals are charged 10% of their paycheck. “First, the unbanked are believed to live at the mercy of fringe banks (pawnshops and check cashers) that charge as much as 10 percent of face value to cash a paycheck” (Washington, 2006). This high interest rate is made even greater when considering the proportions that this face-value charge has considering how much the unbanked makes.

Proposed Solutions:

There is a lot of literature on solutions to empowering the unbanked. There are scholars who believe that the solution toward empowering unbanked consumers is through state legislation. Ebonya Washington (2006) believes that lifeline banking, a state legislation, is a solution. Lifeline banking requires banks to offer low-cost accounts that have very low minimum balance and no minimum check fees. Washington explains that “Activists have argued that lifeline legislation was never given a fair chance to succeed. The failure of banks to advertise these new accounts has thwarted efforts to bank the unbanked. There is evidence that the legislation leads to a small decrease, about three to four percentage points, in the fraction of low-income minority

households without an account." This legislation helps decrease the population of unbanked minority households and create a transition for an individual from unbanked to banked.

John P. Caskey (2002) proposes that a solution for the unbanked problem is involved in five measures. These five measures suggest participating banks opening specialized bank branches that provide CCO services, outlets offering "starter" deposit accounts that have low minimum-balance requirements, cannot be overdrawn, and include access to low-cost money orders for making long distance payments, outlets offering accounts specifically designed to help people build savings, outlets offering deposit-secured emergency loans to individuals whose credit histories make them ineligible for traditional mainstream credit, and outlets seeking community-based partners and offer financial literacy programs.

There is support from articles that use financial innovation to cultivate financial inclusion for unbanked consumers. Matthew B. Gross, Jeanne M. Hogarth, and Maximilian D. Schmeiser (2012) explain how the use of mobile devices can help consumers conduct financial transactions. These innovative financial services and tools may help ease financial access and inclusion in the mainstream financial system for unbanked consumers. The Board's Division of Consumer and Community Affairs (DDCA) conducted a survey "in order to better understand consumers' use of and opinions about mobile financial services."(Gross, Hogarth, Schmeiser, 2012) The survey examined unbanked consumers' ownership and use of mobile phone as well. It concluded that among the unbanked, "63% have a mobile phone compared with 91% of the underbanked and 90 percent of the fully banked." (Gross, Hogarth, Schmeiser, 2012) After concluding the results, it was interpreted that the unbanked consumers widespread of owning smartphones offer great potential for the use of financial inclusion in smartphones. The analysis of the Federal Reserve Board's SCMFS presented here suggests that "mobile technologies offer the potential to better integrate the unbanked and underbanked into the mainstream financial system." (Gross, Hogarth, Schmeiser, 2012) Unbanked consumers would not have to rely on their location of the nearest bank. We can incorporate financial innovation into these smartphones and will help unbanked consumers conveniently check their saving/checking account, deposit a check into their account, or etc. with the use of a smartphone.

Future Research:

There is a need for future research specifically on the topic of the unbanked. Furthermore, this literature review contributes toward the identification of the main theories in unbanked individuals, which can act as a springboard for conducting further exploratory and confirmatory research. Some possible future research is on the true financial literacy of the unbanked. A lot of the theories around being unbanked are based on the unbanked being financially illiterate

and the authors feel that this needs to be examined.

Firstly, there should be more research on individuals' preferences, characteristics and relationship status. There is a chance that these unbanked individuals are female, unmarried, unemployed, and unwilling to take financial risks. William H. Green's(2003) research explains how "unbanked consumers are also more likely to reside in low-to-moderate income (LMI) neighborhoods, to have lower income and net worth, to be less educated, younger, female, unmarried or unemployed." (Greene, Rhine, Comeau, 2003). Unbanked individuals have had serious issues in the past with banks that they are unable and afraid to go back and reopen their checking accounts.

Finally, there is an on-going need to rigorously research approaches to overcome the negative factors and barriers associated with unbanked individuals and what methods are available to manage the change associated with banks. Specifically such research should determine what programs/strategies banks should adopt for successful recruitment of unbanked individuals.

Further, researchers have found that over time more and more individuals have become banked (Hogarth et al, 2005; Rhine et al, 2013). In 1989 nearly fifteen percent of individuals in the United States were unbanked (Rhine et al, 2013). In 2011 that number dropped to 7.7 percent. While an almost fifty percent drop sounds impressive this may be due to some sampling error. Hogarth, Anguelov, and Lee (2005) make an interesting point in that unbanked individuals are often poor and therefore may answer less or have no phone utilities, which may cause differences in measurement of the sample. Future research is necessary in order to see if this pattern of increase in the financial mainstream remains constant over time.

Conclusion:

This paper brings together a culmination of literature on the unbanked. According to Christopher Berry (2004) unbanked individuals are not worse off using CCO. This is contrary to the majority view in the field (Hogarth et al, 2003,2005; Washington, 2006). The authors found that a majority of the literature was the search for the causes of financial exclusion. Hogarth, Anguelov and Lee (2003), Lyons (2004), and Rhine (2000), explain that the causes of financial exclusion are: product design, human capital, product motivation, institutionalist constraints, and mistrust of banks. Hogarth (2003) explains how unbanked consumers may have underestimated the costs of being unbanked. Due to financial education barriers between banks and consumers, unbanked individuals may have a poor estimate of costs of mainstream financial services. This may be a reason that unbanked individuals do not join the financial mainstream. Barr (2002) explains that unbanked people do not make the minimum balance of a checking account when the bank includes high level charging. Unbanked individuals cannot transition from unbanked to bank due to financial barriers keeping up with

the minimum of a checking account. There are a number of solutions being proposed that will bring the unbanked into the financial mainstream. Some of the proposed solutions in the field are to open more banks, increase the frequency of lifeline banking, incorporate mobile banking, and increasing financial literacy. The two solutions that the authors feel are most promising are financial literacy programs and lifeline banking support.

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