

## THE UNBANKED AND THE IMPORTANCE OF NBFIS IN THE US

### ***How the financial crisis, the evolution of Banking and the rise of technology in financial services are all connected***

The financial crisis and the rise of technology in financial services, that has led to an increase in the importance of NBFIs (Non-Bank Financial Institutions) in the provision of financial services, has created a number of challenging situations that might seem unconnected but could be associated to the evolution of a new world financial order. I don't mean the developed/developing world order, but how the banking world and the provision of financial services will evolve amidst the politics, the regulatory environment, the technological developments and the competition in the financial industry – free or controlled, that exists and will exist in the near future.

The two books discussed deal with the unbanked in the United States and how big banks have failed to provide the basic needs that a financial system should provide for the majority of the population and how this failure has opened the market to NBFIs, some of them stigmatized by “preying on the poor” and how small loan providers, such as a fintech company, Insikt, are building programs partnering with the Money Transfer Industry to reach the unbanked.

Can we develop financial service products amidst the derisking or financial services unbanking epidemic?

### **BOOK NO. 1: HOW THE OTHER HALF BANKS - MEHRSA BARADARAN**

[How the Other Half Banks: Exclusion, Exploitation, and the Threat to Democracy](#) by Professor of Law at Georgia University, Mehrsa Baradaran's is very pertinent to the US and should be read if you are deeply interested in the subject. This 2016 Harvard University Press book discusses the involvement of the US government in the banking sector and the creation of “*two separate banking systems today—one serving the well-to-do and another exploiting everyone else*”. It argues that this two-tiered system, where access to safe, affordable financial products and services are a privilege of a few has broken the social contract between the government and financial sector that existed, leaving a thriving financial sector at the public's expense and the poor are left to pure market credit like payday loans: “*a Wild West of fringe lenders and check-cashing joints that answer the needs of everyone else—at a hefty price*”.

The discussion that the book has sparked, such as the very interesting panel “[Inclusion by Default: Toward a Financial System That Works for All](#)” by New America's Washington think tank, while criticizing government & big banks also stigmatizes the “*predatory financial services*” or the “*loan sharks of the market*” that the poor receive, like payday loans and check cashing companies.

A [good review of the book](#) entitled “*A Big Financial Divide*” by Lisa J. Servon – the author of our book I will analyze next, is written in The American Prospect magazine and in the last paragraphs it refers to the postal banking proposal that Ms. Baradan's book addresses: “*it's necessary to compare it [postal banking] to check cashers and payday lenders, since those are the places the “unbanked” are currently*

*getting most of their financial needs met. It wouldn't be too difficult to provide the kinds of services one finds at a check casher—money orders, bill paying, and remittances are not rocket science. (...) The provision of credit is another matter. The kind of underwriting that's necessary to make loans to people who have little or no access to the financial mainstream is difficult and complex.” We will go back to Ms. Devon's analysis after the presentation of her book below.*

## **BOOK NO. 2: THE UNBANKING OF AMERICA – LISA J. SERVON**

The second one is by Professor of City Planning at the University of Pennsylvania and former dean at The New School, Lisa J. Servon entitled “[The Unbanking of America: How the New Middle Class Survives.](#)” The description of the book in Amazon is very telling: “*Lisa Servon delivers a stunning indictment of America's banks, together with eye-opening dispatches from inside a range of banking alternatives that have sprung up to fill the void. She works as a teller at RiteCheck, a check-cashing business in the South Bronx, and as a payday lender in Oakland. She looks closely at the workings of a tanda, an informal lending club. And she delivers fascinating, hopeful portraits of the entrepreneurs reacting to the unbanking of America by designing systems to creatively serve many of us. Banks were once essential pillars of our lives; now we can no longer count on them to do right by us.*”

In a report by PBS entitled “[The surprising logic behind the use of check cashers and payday loans](#)” by PBS correspondent Paul Solman, a journalist who has specialized in economic reporting since the 1970s, interviews Joe Coleman, President of RiteCheck, several clients and author Lisa Servon who wondered why lower-income people who were struggling would cash checks instead of getting a bank account, taking a job as a cashier to find out. What she learned -- that it's often cheaper -- is the subject of her book. Paul Solman asks Lisa on the payday loans clients take: *But aren't the payday lenders taking advantage of these people?* She rightfully responds: “*It's a very hard question to answer, the question really being, are payday loans helpful or harmful, or, alternatively, is very expensive credit better than no credit at all? And I would say that the jury is still out on that question.*”

Ms. Servon writes in the [review of Ms. Baradaran's book](#) entitled “A Big Financial Divide”: “*Making loans that carry even a 36 percent interest rate—a rate that's considered usurious in some states—is tough to do. Oportun, a small-dollar lender based in California, has spent nearly a decade working to develop underwriting criteria, and turns a modest profit by offering loans at an average annual percentage rate (including fees) of about 38 percent, and by approving approximately half of all loans from new applicants.*” This quote opens a note about small loans and Insikt, a fintech that participated in our past IMTC USA 2017 conference and is developing loan products for the unbanked in the US and partnering with Money Transfer Companies to reach a growing client base.

## **OPPORTUNITIES FOR NBFIS: SMALL LOAN SERVICES**

In the wake of the financial crisis, bank lending in the US collapsed. Many businesses and individuals were unable to access credit—just when they needed it most. In response, the banks hunkered down and lending went into lockdown and didn't recover to those same levels until September 2013, a full five

years later<sup>1</sup>. The online lending revolution in P2P, B2P and B2B lending began to grow and in 10 years, P2P lending has facilitated over \$35 billion of loans in the US. It is believed that the P2P share of unsecured consumer loans is projected to enjoy a compounded annual growth rate of 47%, rising to 8.4% of the market by 2020. B2B lending is expected to grow to 16% by 2020.

Most of these loans are going to people with credit, even if credit is not perfect. But what about people with no credit history?

[Insikt](#) is a California-based fintech, a white label loan origination and investing platform that enables any brand to lend to its customers. The company believes that the key to serving the underbanked is not only to offer a responsibly structured and affordable credit product that allows borrowers to budget loan payments over a longer period of time, but to offer a credit-building gateway into the financial mainstream. Insikt believes that there are many ways that the unbanked can build good credit records and that the money transfer industry has records, invaluable data, of their customers transaction history that can be harnessed to build those needed credit records.

A key for the company is how to meet the critical need for loans to the most vulnerable Americans without trapping them in debts that worsen their problems. Insikt is keen to point out to two studies.

The first one is from the Center for Financial Services Innovation (CFSI) [who partnered with IMTC in our past IMTC WORLD in the MTFinX workshop] that states in their website<sup>2</sup>: *“Market Research on Consumer Financial Health shows 57% of American adults struggle financially. Many are dealing with an unhealthy amount of debt, irregular income, and sporadic savings habits. With our vision, we invest in innovative technologies, policies, and providers that help Americans overcome those obstacles so that they can thrive. But no single financial product can enable individuals to reach this goal alone; it requires collective creativity, collaboration, and investment from across the financial services industry.”* The second one is the Report on the Economic Well-Being of U.S. Households in 2015<sup>3</sup> published by the Federal Reserve in May 2016 which states: *“46% of US adults say they either could not cover an emergency expense costing \$400, or would cover it by selling something or borrowing money. 22% of respondents experienced a major unexpected medical expense that they had to pay out of pocket in the prior year, and 46% of those who say they had a major medical expense report that they currently owe debt from that expense.”*

An estimated 94 Million Americans have non-prime credit scores, while another 45M are credit invisible. For most, payday loans might be their only alternative and the only way to fix their car to go to work, or to cover a hospital bill. Payday loans are expensive and even if borrowers pay the loans in time (which a very small percentage do) the payments typically are not reported to the credit bureaus, which means they are not getting rewarded with improved scores.

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<sup>1</sup> <https://www.forbes.com/sites/oliviergarret/2017/03/06/how-to-join-the-p2p-lending-revolution-and-earn-10-yields/#269eed4b6a7c>

<sup>2</sup> <http://cfsinnovation.org/research/financial-health/>

<sup>3</sup> <https://www.federalreserve.gov/2015-report-economic-well-being-us-households-201605.pdf>

Americans that are locked out of the mainstream financial system have only one way back in: they need to borrow and repay a loan, and they need a creditor to report the success to a national credit reporting agency. And companies like Insikt are focused on helping borrowers build credit. Insikt mentioned that after three successful loans, borrowers with no credit have been able to build FICO scores to 660. In addition, an important feature of Insikt loans includes offering credit only to borrowers who have the ability to repay their debts, by verifying the borrower's income, expenses, and debt to income levels. They also never allow for refinancing a loan – borrowers must repay their loans in full before they can apply for a subsequent loan to avoid the debt trap problem.

Companies like Insikt cannot operate in all the states. Some states, New York is an example, implemented a 25% interest rate cap which has barred payday lending in the state. Unfortunately, these laws that are meant to prevent “*predatory lending*” are significantly limiting other credit products and discouraging consumer friendly small dollar lending. Supporters of the cap argue that New York's community development credit unions are already meeting the need for such credit. But most lenders simply do not believe they can have a sustainable business model given current state law. California has taken a different approach and has seen very positive results. Five years ago, California's Legislature unanimously passed a pilot program for small dollar loans to encourage consumer friendly alternatives to payday loans. The program where six lenders and six finders participated as stated in the *Report of Activity Under Small Dollar Loan Pilot Programs*<sup>4</sup> showed great results, summarized here:

- **Borrower applications** increased by 58.5 percent over the period, from 207,092 in 2011 to 328,198 in 2014. The loan approval rate increased from 39 percent in 2011 to 50 percent in 2014.
- **Aggregate principal** – The annual total principal of loans made over the period increased by 83.8 percent, from \$97.9 million in 2011 to \$179.9 million in 2014.
- **Dollar amounts** – Loans made in the \$300-\$499 range fell by 42.3 percent over the period, from 1,518 in 2011 to 876 in 2014. Loans made in the highest range, from \$1,500 to \$2,499, increased by 106 percent, from 21,349 to 43,975.
- **Interest rates** – Of the 6,560 loans made in the \$300-\$499 range over the period, 73.9 percent carried an annual percentage rate (APR) of 40 percent to 49.99 percent. In the \$500-\$999 range, 43.4 percent carried APRs of 40 percent to 49.99 percent, and 25.2 percent had APRs of 35 percent to 39.99 percent.
- 45% of borrowers in 2014 used the loans to build or repair credit and 77% of borrowers said the length of the loan was long enough to let them make loan payments without creating substantial hardship.

Insikt is working very closely with Money Transmitters in the US and their loan product is now at company branches and agents where they are training the cashiers to offer the product and answering the questions that come up. Money Transmitters are one of their best partners because the clients trust them, are used to send money to their families, are happy with the remittance services they receive and the trust factor is very important for these customers to try a new service or to switch from other providers that they use or might have used in the past. Agents can make the client more loyal and the

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<sup>4</sup> [http://www.dbo.ca.gov/Licensees/Finance\\_Lenders/pdf/Pilot%20Program%20Report%202015%20Final.pdf](http://www.dbo.ca.gov/Licensees/Finance_Lenders/pdf/Pilot%20Program%20Report%202015%20Final.pdf)

product can create a new revenue stream for them and the MTO.

## **THE UNBANKING IN AMERICA IS PART OF THE GREAT GLOBAL UNBANKING**

Let's start from this quote of Lisa Servon's book: *"The big banks have demonstrated a lack of interest in providing the financial products and services at a price we can afford. They will not address the problem on their own. The only way to guarantee that all of us will have the ability to achieve financial health is for the government to intervene and play a larger role in the provision of financial services"*.

And then Lisa goes into three options: one, to subsidize banks to serve those customers who are not profitable, two, to enable mission-oriented banks and credit unions to extend their reach and three, for the federal government to provide banking services and she mentions the potential for the post office to provide those services.

Although the three options open up the discussion on what to do, I am very curious why Lisa didn't explore a fourth option which is what Europe is working on and that is creating competition to banks by allowing payment institutions (*money service businesses in US terminology*) to have a regulation where they can provide, with the help of fintech and the use of mobile technology, of a wider array of financial services. That way innovation is fostered and customer-specific products can be developed. There are so many possibilities being explored and many more would be certainly developed if the conditions improve. Just as an example: mobile prepaid card type of products can easily compete with bank accounts. But for that, banks will have to be enticed to work with these providers of financial services which are competing with them and provide banking services to them. And that is not happening; derisking is moving the unbanking issue to financial service providers.

In our next article, we will discuss the "Great Global Unbanking", as being labeled by The Economist, that is causing so many financial services providers with no bank accounts to work with. We will base next week's blog on these two articles from The Economist:

- [The great unbanking](#): *Swingeing fines have made banks too risk-averse - It is time to rethink anti-money-laundering rules*
- [Rolling up the welcome mat](#): **A crackdown on financial crime means global banks are derisking** - *Charities and poor migrants are among the hardest hit*

Let's end with another quote from Lisa's book: *"Even with so much fertile ground for innovators, it's unclear whether the best ideas will reach the consumers they could benefit most. Government regulation is one of the most difficult pieces of the puzzle"*. Of course we do agree with you, Lisa.