Sarah Bloom Raskin: Economic and financial inclusion in 2011 – what it means for Americans and our economic recovery

Speech by Ms Sarah Bloom Raskin, Member of the Board of Governors of the Federal Reserve System, at the New America Foundation Forum, Washington DC, 29 June 2011.

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The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

I wish to thank the New America Foundation, the Center for Financial Security, and the Congressional Savings and Ownership Caucus for the invitation to speak at this important conference addressing the savings and credit needs of Americans as our economy recovers. It is a pleasure to be here with you today.

As the mother of three teenagers who are struggling toward adulthood – always two steps forward and one step back, or perhaps a couple steps sideways – I inevitably think about economic inclusion from the standpoint of young people entering the workforce and the adult economy. And so I ask myself: What does it mean for them to be included in the economy?

Well, obviously I want them to be able to find satisfying, meaningful, and decently compensated work. Surely this is as much a marker of the transition to adulthood in our society as registering to vote or earning the all-important driver's license. We might say that we are not truly included in the economy until we draw our first paycheck. One of the tragedies of our current lingering recession is that so many young Americans have not been able to experience the thrilling rite of passage that comes with finding a stable and decent-paying job. And, of course, even beyond the young, there are millions of Americans stuck in unemployment lines desperate to find a way back into the productive economy.

The question of employment is not our focus today, but we should pause to underscore the promotion-of-maximum-employment imperative of the Federal Reserve's dual mandate. I believe that this imperative has broad importance in American social and economic life.

But economic inclusion also implies a kind of belonging and membership in the economy that goes beyond employment. In the financial and regulatory world, "economic inclusion" refers to efforts to expand public access to, and participation in, mainstream financial services. This effective inclusion in the financial marketplace depends upon a strong regulatory framework, active market participation, and an expansion in public financial literacy. For the sake of clarity, I will call this meaning "financial inclusion," and proceed on the assumption that it is indispensably important to effective navigation of the twists and turns of life in the American economy. Imagine what it would be like, even with a job, if you had no access to banking or credit; if you did not understand how mortgages or credit cards work; or if you had no way to save a portion of your earnings. Sadly, there are millions of Americans lingering in these margins.

In my remarks today, I will share my perspective on why broad inclusion matters to our economic recovery, the challenges that current economic conditions present to the efforts of lower-income Americans to participate in the economy, and the risks we face as a country if we understate or misunderstand these challenges.

Who is being excluded?

Let's first try to scope who is at risk of being economically excluded. We start with the unemployed. The latest employment report issued by the Bureau of Labor Statistics was

bleak.[1] U.S. employers in May added only 54,000 non-farm jobs, down from 232,000 jobs added in April. The headline unemployment rate was 9.1 percent in May, representing about 13.9 million Americans out of work.

Unfortunately, the headline unemployment numbers don't fully capture the true scope of the unemployment problem. There are an additional 8.5 million workers who are "part-time-of-necessity" or "underemployed" because their hours have been cut back or they are unable to find a full-time job; there are also 1.4 million workers who are "marginally attached" to the labor force because, while wanting a job, they have not searched for one in the past four weeks; and there are 822,000 "discouraged" workers who have given up searching for employment because they do not believe any jobs are available for them.[2]

So it is not just those who are currently collecting unemployment insurance payments who are excluded. The underemployed, the marginally attached, and the discouraged, all of whom are primarily concerned about the security of their jobs, wage growth, housing, and the rising cost of living, are also suffering from exclusion from the economy of work.

But most of these people searching for a way back into the employed economy are doubly challenged by their ability to access reasonably priced financial products with safe features that encourage savings. Americans have several core financial needs. They need a safe, accessible, and affordable method to deposit or cash checks, receive deposits, pay bills, and accrue savings. They also need access to credit to tide them over before their next cash infusion arrives. They may be coming up short paying their rent, their mortgage payment, an emergency medical expense, or an unexpected car repair. They may want access to a savings vehicle that, down the road, will help them pay for these items and for education or further training, or to start a business. And many want some form of non-cash payment method, such as a credit or debit card, to conduct transactions that are difficult or impossible to conduct using cash.

Products and services that serve these core financial needs are not consistently available at affordable rates to all Americans. Those with low and moderate incomes may have insufficient income or assets to meet the relatively high requirements of banks. Americans without jobs, or with jobs that have slow wage growth, have little, if any, opportunity to establish a credit history that facilitates access to financial services. Others, especially in the wake of a recession that put many people out of work and homes, may have dents on their credit records that inhibit their ability to borrow on affordable terms.

How the recession undermined financial inclusion

The economic crisis has undermined financial inclusion for many Americans. Low- and moderate-income families entered the recession with little financial buffer against the adverse effects of wage cuts, job loss, and drops in home values. According to the 2007 Survey of Consumer Finances (SCF), home equity accounted for 75 percent of total assets for low- and moderate-income families, which made them extremely vulnerable to the eventual housing market collapse. Sure enough, families in the bottom fifth of the income distribution saw an 18 percent drop in median net worth between 2007 and 2009, going from $8,100 in 2007 to $6,600 by 2009.[3,4] Families in the middle of the income distribution fared

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1 Bureau of Labor Statistics. "The Employment Situation – May 2011."

2 Ibid.

3 Bucks, Brian K., Arthur B. Kennickell, Traci L. Mach and Kevin B. Moore. 2009. "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, v. 95, pp. A1–A55.

even worse, experiencing a 21 percent decline in the value of their assets, the highest of any group during the same period. Combined with widespread unemployment, housing and stock price declines, and increasing rates of mortgage defaults, foreclosures, and bankruptcies, the assets of many American families have been significantly eroded.

In addition to losing the value of their savings and assets, a significant number of low- and moderate-income families have become financially marginalized as a result of the economic crisis. The percentage of families earning $15,000 per year or less who reported that they have no bank account increased between 2007 and 2009 such that more than one out of four families were unbanked.[5] Families slightly further up the income distribution earning between $15,000 and $30,000 per year are also financially marginalized: 13 percent report being unbanked and almost 24 percent report being underbanked.

This combination of economic insecurity and financial marginalization has placed more low- and moderate-income families right at the well-lit front doorsteps of payday lenders and other alternative financial service providers to try to meet their financial needs.

Alternative financial services: convenience vs. cost

While alternative financial services may serve the access needs of many consumers, they often come at a much higher cost than traditional financial services. For example, the typical payday lender may charge $15 to $20 per $100 borrowed for a two-week period, translating into annual percentage rates often exceeding 390 percent. Similarly, check cashers generally charge customers 2 to 3 percent of the amount of a check, even for those issued by the government. It is not hard to see how such fees can add up to several hundred dollars per year – real money for any consumer, but as a percentage of income, much more costly for those with limited disposable incomes.[6]

For some consumers, these services may be seen as more convenient or customer-friendly than those offered by traditional banks. But this convenience comes with a hard price: it further exacerbates the precarious financial state of many families and, in many cases, locks them into a downward cycle of deteriorating finances.

This is not to say that mainstream financial services are inexpensive. Free checking accounts are quickly disappearing, replaced by accounts with rising fees. Overdraft fees on checking accounts can also be pricy, ranging from $10 to $38 with a median fee of $27. These fees are not insignificant, particularly when applied to small dollar transactions.[7]

In sum, the financial crisis has left many lower- and moderate-income Americans in danger. With fewer assets to rely upon and deteriorating credit, many people find it harder to enter, or stay in, the financial mainstream. In analyzing the state of economic and financial inclusion, the crisis both expanded the number of Americans excluded from the economy and dramatically raised the barriers to enter it.

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[4] Bricker, Jesse; Brian K. Bucks, Arthur B. Kennickell, Traci L Mach, and Kevin B. Moore. 2011. "Surveying the Aftermath of the Storm: Changes in Family Finances from 2007 to 2009 (212 KB PDF)" Finance and Economics Discussion Series 2011–17.

[5] See FDIC National Survey of Unbanked and Underbanked Households; Bucks, Brian K., Arthur B. Kennickell, Traci L. Mach and Kevin B. Moore. 2009. "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, v. 95, pp. A1–A55.

[6] See Desmond, Tyler and Charles Sprenger. 2007. "Estimating the Costs of Being Unbanked (199 KB PDF)" Federal Reserve Bank of Boston.

[7] See FDIC Study of Overdraft Fees.

Why does financial inclusion matter?

Broad financial inclusion is essential because it bolsters American consumption and savings, which drives macroeconomic growth. In order to promote efficient economic growth and stability, Americans must have safe and affordable access to the tools necessary to function in the modern economy. Congress created the Federal Reserve with a view that it should focus on economic growth, so the Federal Reserve has a clear interest in promoting a meaningful, broad recovery that is conducted in a safe and viable manner. Affordable, transparently priced, and safe financial products and services promote positive outcomes for individual consumers, which in turn supports the growth and stability of the overall financial system.

From the standpoint of the individual, financial inclusion serves as a mild counterweight to the growing income and asset inequality in the United States that has deepened since the onset of the economic crisis. While the exact level of inequality is a matter of academic debate, the trend across various measures definitely suggests that economic disparity has increased over the past 30 years and has accelerated in the past decade.

This phenomenon appears to be driven primarily by the rapid growth in income and assets for those in the top 1 percent of the distribution, while most everyone else has experienced stagnation.[8] This inequality is destabilizing and undermines the ability of the economy to grow sustainably and efficiently. It is associated with increases in crime, profound strains on households, lower savings rates, poorer health outcomes, and diminished levels of trust in people and institutions.[9] All of these forces drag down maximum economic growth and are anathema to the social progress that is part and parcel of such growth. These forces also bring people closer to being "scammed" or becoming vulnerable to financial schemes that promise quick and easy fixes. Finding ways to help more Americans safely grow their incomes and net worth in real terms arguably diminishes the destructive influence of income inequality by giving everyone a more secure footing in the economy and the same kind of flexibility and choice available to the more affluent.

Understanding the impediments to inclusion

Understanding the impediments to inclusion for Americans will help policymakers to craft effective responses for expanding access to financial services. As just described, first and foremost, people need jobs with compensation that can support them and their families and that provide a source of savings and wealth accumulation. In other words, they need to be economically included. Second, we should examine barriers that individual consumers may face.

For example, a Federal Reserve analysis of the SCF suggests that the primary reason individuals do not have a transaction account is a simple lack of trust in financial institutions.[10] This may originate from negative personal experiences with financial institutions since more than half of the unbanked previously held checking accounts. For

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[8] Kennickell, Arthur B., "Ponds and Streams: Wealth and Income in the U.S., 1989 to 2007," Federal Reserve Board, Finance and Economics Discussion Series, 2009–13 (2009); Burkhauser, Richard V., Shuaizhang Feng, Stephen Jenkins and Jeff Larrimore. 2011. "Recent Trends in Top Income Shares in the USA: Reconciling Estimates from March CPS and IRS Tax Return Data." *Review of Economics and Statistics*. forthcoming

[9] Daly, Martin, Margo Wilson, and Shawn Vasdev. (2001). "Income Inequality and Homicide rates in Canada and the United States," Canadian *Journal of Criminology*, April: 219–236; Levine, Adam Seth, Robert H. Frank, and Oege Dijk (2010). "Expenditure Cascades" (September 13); OECD (2011), *Society at a Glance 2011 – OECD Social Indicators*

[10] Hogarth, Jeanne M., Christoslav E. Anguelov, and Jinkook Lee. (2004). "Why Don't Households Have a Checking Account?" *Journal of Consumer Affairs*. 38 (1), 1–34.

some immigrants, it may also be due to a more general distrust of financial institutions in their country of origin that translates to distrust of U.S. institutions.

Opportunities for innovation

In addition to considering the barriers to accessing transaction, savings, and credit products, the discussion of expanding financial inclusion should consider new opportunities that have the potential to make financial services more broadly available. New technology, such as recent advancements in mobile financial services and the prepaid card industry, are spurring financial product and service innovation in the private sector. For example, mobile tools promoting ways to improve the financial capabilities of, and providing new products and services for, the underbanked are being developed.

At the same time, there is interest in the use of prepaid cards that offer the payment ability of a debit card, combined with the functions of a checking account, to go along with an optional savings feature, as a new product that provides expanded options for consumers without traditional bank accounts. New features, incentives, and discounts are beginning to flourish as the prepaid market expands and more competitors enter the marketplace. In fact, at least one prepaid card option encourages timely bill payment and savings by providing a discount coupon for prepaying a bill. For instance, a consumer with a $20 utility bill would get a $2 discount for paying the bill early, with the $2 going into a savings account.

Partnerships are another strategy for delivering financial services at a low cost. For instance, the Bank On initiatives being launched throughout the country are an example of how partnerships between banks, credit unions, local governments, and non-profits can lead to the development and deployment of low-cost products that are designed to meet the needs of low-income consumers. Bank On campaigns seek to provide pathways to safe, affordable financial products, such as low- and no-cost checking accounts that are offered by participating financial institutions.

In addition to the wide range of work engaged in by the Federal Reserve System that is designed to foster and promote financial inclusion, the System's Community Development function conducts outreach and acts to foster partnerships and provides research and analysis necessary to understand the challenges confronting low- and moderate-income individuals and households. By leveraging our strengths as a research institution through the network of Community Development staff in the 12 Reserve Banks, their 24 branches, and the Board of Governors, the Federal Reserve System is able to monitor and respond to changes in the financial services industry while positively influencing policy that impacts low- and moderate-income consumers.

Changing demographics

Our collective work in the realm of financial inclusion is occurring within a landscape for financial services and consumer credit that is changing quickly. Racial and ethnic diversification of the country presents opportunities for financial service providers that are attentive to the changing financial needs and preferences of consumers. Rising immigration from developing countries, and the associated diversity of experience with formal financial services providers, will challenge the financial services industry to be more flexible and creative in reaching consumers.[11]

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[11] Hogarth, Jeanne M.; Marianne A. Hilgert, Edwin Lucio, Ana Cruz-Taura, Sibyl Howell, Jessica LeVeen-Farr, Elizabeth, McQuerry, Juan Sanchez, and Wayne Smith,. (2005). "Banking on Remittances: Increasing Market Efficiencies for Consumers and Financial Institutions." *Promises and Pitfalls – Federal Reserve System's Fourth Community Affairs Research Conference*, 2005.

To return to where we began – with teenagers – those of us that are privileged to share our days with them know how technology is absolutely central to their lives. Their familiarity and comfort with online interaction, combined with their expectation of immediate, continuous, and universally accessible service, will likely inspire changes to traditional models of financial service delivery. Traditional financial service providers that fail to keep pace with the latest technological innovations risk losing market share to innovators in this area. Signs that younger Americans are more tenuously attached to the traditional financial system are already apparent and it is important for policymakers to understand the implications of this trend for the financial futures of the next generation.[12]

It may, in fact, turn out to be that the innovations in financial services outside the traditional banking system will best address the needs of lower-income Americans. However, it is incumbent upon regulators to ensure that these products and services are safe, affordable, transparent, and easy to understand, regardless of the provider. In some cases, regulators may need to ban products that are inherently unfair or deceptive. In all cases, regulators must ensure that consumers are afforded meaningful protections with respect to any products that are offered in the financial marketplace. Finally, regulators must also actively monitor the consumer financial market to guard against developments that might threaten the stability of the overall economy.

Conclusion

To conclude, the financial crisis has created new challenges in ongoing efforts to expand economic and financial inclusion. The large numbers of unemployed and underemployed Americans are at great risk of being unable to access fair, sustainable, and affordable financial services. It is necessary for the strength of our nation's recovery that low- and moderate-income Americans be able to more fully participate in the economy, and both policymakers and financial innovators should remain committed to the imperative of building upon the progress that has been made. We need to be prepared to foster further innovation and outreach. Our overall economic stability relies ultimately on the collective financial health of all American households, so these are issues in which we all have a stake. One of the positive commitments that can emerge from this period of terrible economic distress is the determination that all Americans, regardless of income, have access to reasonably priced financial products and services so that they may fully participate in our nation's economy and safely build assets for their futures.

Thank you.

[12] Stone, Corey and Joshua Sledge (2010), "Financial First Encounters: An Examination of the Fractured Financial Landscape Facing Youth Today." (320 KB PDF). Center for Financial Services Innovation.