Remarks by
John D. Hawke, Jr.
Comptroller of the Currency
Before the
ABA National Community and Economic Development Conference
Baltimore, Maryland
March 18, 2002

Banking is one of our nation's most mature industries -- mature in the sense that economists use the term -- and as I increasingly use it, as a euphemism for advancing age. Indeed, banking grew in lockstep with America, beginning by serving the modest financial needs of a nation of small towns and subsistence farmers, then fueling the rise of the mighty industrial and technological economy we know today.

Banking is also mature in the sense of its penetration of the present-day market for a distinctive array of financial services. The reach of the banking system -- in the form of bank-originated home mortgages, small business loans, credit cards, and deposit accounts -- is greater today than ever before. Three-quarters of all adults now own at least one credit card; 96 percent of all U.S. households with income over $25,000 annually hold bank deposit accounts. Obviously, today's consumers have a wide range of options among financial providers, and banks must contend with a more crowded marketplace for products and services it once dominated. But gloomy predictions that we would find that the industry's best days were behind it have proved wrong, and the banking franchise today is as strong as ever.

This record is a source of justified pride to the industry. But it also raises the question that industry leaders have been grappling with for years: where do we go from here? Despite the industry's rapid consolidation over the past decade, meaningful gains in the market for traditional bank products have proved highly elusive -- and expensive to achieve. Each year, for example, credit card issuers churn out new billions of direct mail solicitations to potential customers, and get proportionately fewer and fewer responses in return -- 0.6 percent in 2001, down 50 percent in only three years. And bankers have come to recognize that the customers gained in this low-yield manner are likely to stay customers only until a competitor comes along with a better deal. In the zero sum game that financial services competition has become, every gain to one provider represents a subtraction to another.

So where should banks turn to achieve the growth -- and the profits -- they feel they must have to attract capital and stay vigorous? Some institutions are taking advantage of recent changes in laws and regulations that now permit them to compete in markets for such products as insurance, securities, and investment services. But while the potential for growth in these areas is no doubt substantial, it's also clear that banks wading into these jungles will find them thick with competitors who have been there longer, know the territory better, and are unlikely to yield their dominance without a fight. Gains in these markets, too, are not likely to come easy -- which may be why banks have edged so cautiously into those areas.

So it seems logical for banks to aggressively pursue opportunities to expand the market for traditional bank products, by fashioning those products in new and more responsive ways to a broader range of customer needs -- in short, by bringing new customers into the mainstream of the banking system. Where those opportunities exist -- and how to capitalize on them -- are among the questions that have brought us to Baltimore.

The conference program suggests the range of market-building opportunities that are there for the taking. Let me mention three areas that seem to hold particular promise. The first is small business lending. Although the number of minority-owned businesses has increased dramatically in recent years, the use of bank credit by those businesses has lagged well behind that of their peers. According to a recent Survey of Small Business Finances, only two-thirds of minority-owned businesses used credit, compared to over three-fourths of all businesses. For African-American owned businesses, the numbers are even lower. Clearly, there's a subset of the small business market that banks have only begun to serve.

That's also true in the area of home ownership. Although the U.S. home ownership rate is now nearly 68 percent -- an all-time record -- the rates for African-Americans and Hispanics remain below 50 percent. The gap between these rates represents approximately $600 billion in potential home mortgages -- a sizeable market opportunity for banks.

Last but not least, there are important opportunities to build mutually profitable relationships with millions of ordinary Americans who do not conduct all of their routine banking transactions with banks. I'll use the term "underbanked" to encompass two groups. First, there is the nearly 10 percent of American households that still do not have a deposit account at a financial institution and rely heavily on nonbank financial service providers for their basic banking needs. People without formal account relationships may still occasionally use banks as a secondary source of financial services -- for example, when they cash a third-party check at the bank of issue. But nonbank financial outlets are where the majority of their financial services are obtained.

I'm also using the term "underbanked" to refer to what is customarily characterized as an entirely separate population: individuals who rely to a greater or lesser extent on high-cost short-term credit provided by nonbank lenders, often in the form of "payday" or "cash advance" loans.

On first glance, the argument that these are two markets rather than one seems compelling. By definition, people without bank accounts cannot also be payday loan customers -- at least as the payday loan business is now generally conducted -- for such loans, secured by postdated checks, obviously require customers to have active checking accounts in good standing. That makes for some demographic differences, too. Payday loan customers, like the majority of Americans with banking relationships, out-earn people without bank accounts -- although the household income of payday borrowers places them somewhere between the average non-account holder and the average bank customer.

Yet analysis reveals important similarities between those Americans without bank accounts and the typical payday loan customer -- similarities suggesting that much of what we know about one population may be applicable to both. First, the two populations may patronize identical nonbank financial outlets, some of which, as I've noted, provide a well-stocked menu of financial services. Second, both populations -- irrespective of household income -- are likely to contain large numbers of people living near the edge economically, with few financial resources to fall back upon.

But perhaps the most salient similarity is that both populations have turned away from banks -- or have been turned away <u>by</u> banks -- in obtaining at least some of the financial services they regularly need. And that, I believe, may help to explain <u>why</u> they are living near the edge. Some may be paying more for financial services than they need to; others are missing out on opportunities to build financial assets and relationships so crucial to long term financial independence.

What's more, the two groups are underbanked for many of the same reasons -- reasons I'll discuss momentarily

This situation poses a challenge for banks -- and an opportunity. The challenge is to understand why people who might become bank customers aren't doing so. The opportunity is to change their minds and their financial habits. It's a high-stakes undertaking -- for banks, for current and potential bank customers, and for our economy.

On one point -- the magnitude of the potential market for banks -- there is little controversy. The nonbank financial industry is huge -- and growing.

For example, in 2000, Americans cashed 180 million checks at 11,000 check-cashing outlets, generating fees of $1.5 billion.

No segment of the nonbank financial industry has grown more rapidly than payday lending. Ten years ago, the payday loan industry hardly existed. Today up to 10,000 outlets nationwide provide payday loans totaling between $8 and $14 billion, generating fees totaling up to $2.2 billion. California alone has more payday loan offices -- nearly 2,000 -- than it does McDonalds and Burger Kings, and other states are not very far behind.

No matter how you slice it -- and different sources slice it different ways -- the nonbank financial services industry earns immense profits. A U.S. Treasury Department study of check-cashing and payday lending showed average pretax returns on sales of 34 percent. Payday lenders in Chicago, according to another study, realized a return on investment of 24 percent. ACE Cash Express, the biggest of the national check-cashing companies, with more than 1100 outlets, reported average store profits of 23 percent for fiscal year 2001 -- up 25 percent over a year earlier.

How can we account for this extraordinary growth? The answer lies in an understanding of the needs and the barriers facing the customers of nonbank financial providers. Developing that understanding is a step that mainstream financial institutions must take before they can hope to expand their presence in the underbanked market and provide the underbanked with the benefits of more comprehensive banking relationships.

To assist in that understanding, the OCC recently sponsored a survey of individuals living in low- and moderate-income neighborhoods of two major urban areas: Los Angeles County and New York City. We polled over 2000 randomly selected individuals about their financial habits and experiences. From our results we can draw statistically valid inferences about the 2.6 million individuals who live in the low- and moderate-income neighborhoods in these two major urban areas.

One inference that may be drawn from our study is that people who lack formal banking relationships may be just as responsive to market incentives as people who have those relationships. In other words, appearances to the contrary notwithstanding, check-cashing customers, payday borrowers, and consumers of other relatively high-cost nonbank products do business outside the banking system for practical -- and economically rational -- reasons. This is an exceedingly important point, because it is sometimes mistakenly assumed that people with low incomes lack the acumen to make sound decisions in their own self-interest.

Two complementary realities shape the check-cashing behavior of people without formal banking relationships. First, these individuals generally spend a good deal less in check-cashing fees than one might imagine, given the high per-check fees that check-cashing outlets usually charge. A substantial portion -- 16 percent -- of this segment of our survey population received their income entirely as cash, and thus had no reason to do business with check-cashers. Of those who did receive checks, 23 percent usually cashed them -- and usually free of fees -- at a bank, most likely the bank on which the check was drawn.

Those who did use check cashers, moreover, tended to use them sparingly. Ninety-seven percent of that population received four or fewer income checks per month; households earning $15,000 a year or less typically received two checks per month. Eighty-five percent of those without formal banking relationships used three or fewer money orders per month. Check-cashing outlets charged an average of $3.38 per check, and an average of $1.00 per money order. Nevertheless, as I've noted, many of those without formal banking relationships did not use check cashing or money order services, and not all of those who do use those services obtain them from check-cashing outlets. Thus, when we consider all of those without banking relationships in our study population in New York and Los Angeles, we find that only about one third of these households wound up incurring total check-cashing and money order costs of $100 or more per year.

I am by no means belittling the importance of even $100 a year to a low- or moderate-income family -- and the reality elsewhere in the country may be different from these findings for two large urban areas. But that may be the best deal available in the current financial services marketplace for people who have to pay for check cashing. As I said, there's a second financial reality that shapes the behavior of check-cashing customers: the fact that while check-cashers charge a lot, most banks charge more for the same services. According to a 1999 study by the U.S. Public Interest Research Group, the average minimum balance required to <u>avoid</u> fees for checking accounts at large banks was $616. Consumers who were unable to meet that minimum balance requirement -- and a great many simply do not have enough savings to do so -- paid an average of $218 a year, or $18 a month, to maintain a checking account. For people who may typically cash only a few checks and make only a few payments per month, such bank accounts do not make sense. Indeed, earlier surveys have strongly indicated that the principal reason people give for not having a bank account is that it costs too much for their needs. And while many banks have developed a variety of inexpensive products appropriate for low-income customers, they are often not well publicized.

In my view, banks that do not now offer these inexpensive products should strongly consider doing so. And those that already have them should do more to bring them to the attention of current and potential customers.

Payday borrowers too often lack good low-cost options. They typically patronize payday lenders not because they are unaware of the high cost of the credit obtained from that source, but because they have few better places to turn. According to a recent Georgetown University study, the typical payday borrower, needing perhaps $200 to deal with an emergency -- or simply to bridge from one payday to another -- is unlikely to have a usable credit card, an overdraft line of credit, or relatives willing and able to help. As a last resort, they might bounce a check -- and face $50 or more in overdraft fees plus the risk of having the account closed -- or, if they own their own home, apply for a home equity loan and wait weeks for a line of credit far larger than they actually need. In that light, the $30 or $40 that a payday lender might charge for fast approval of a two-week, $200 loan doesn't seem so far out of line.

It's worth noting here that payday borrowers don't seem to be at all deterred by high APRs. The Truth-In-Lending disclosure statements they are given reflect APRs that may range as high as 900 percent, but borrowers seem to focus on the immediate dollar cost rather than the annualized rate.

The real damage, of course, occurs over time. It's not the single payday loan that buries the borrower; it's when payday finally arrives, and the borrower can't comfortably pay back the loan. Then the borrower must pay another fee to roll the loan over for another two weeks -- and then for another. According to the Georgetown study, three-quarters of all payday borrowers renewed their loan at least once, with about 30 percent reporting 7 or more renewals. It's when they mount up -- when a new loan is taken to repay one that has come due -- that the APRs become astronomical and the borrower gets trapped in an increasingly costly cycle.

Similarly, the relatively small sums that people without a formal banking relationship spend to cash a few checks and buy a few money orders are not the problem. It's the compound effect of lost opportunities to build wealth and make a better life that is the problem. It's the cash tucked away -- not safely in a savings account, but in a coffee can or hip pocket, vulnerable to theft or loss -- that sets people back in their struggle to get ahead. It's a problem measured in homes that will never be purchased, in businesses that will never be built, and in the financial security that will forever remain out of reach.

The loss is one we all share -- on many levels. For banks, it's a business loss -- and it's an avoidable one. I believe that banks are uniquely positioned to provide options and opportunities that the underbanked currently lack. But doing those things requires first a sophisticated understanding of the market and the opportunities, and second a commitment from banks to fashion products and services that are consistent with reasonable profit expectations and responsive to what these customers want, at competitive prices they can afford.

Prices they can afford, consistent with reasonable risk-related profit. That's the rub. Banks are not in business to give away their services. But the poor and near poor have limited resources to spend on financial products. We know approximately what those limits are because we know what the underbanked are spending at nonbank outlets today. And some bankers have looked at those numbers and then looked at what it would take to deliver a comparable array of products and services, and concluded that it cannot be done -- or that it's too much trouble even to try.

Maybe there was a time they were right. But today's bankers have an ally in the effort to profitably serve the underbanked. The military refers to technology as a "force multiplier" -- a means to maximize resources and shift outcomes. It can be that for the banking industry as well in the effort to profitably serve the underbanked.

Technology has already revealed its potential in this regard. In the Electronic Transfer Accounts now being offered by hundreds of financial institutions around the country, we have the prototype of a technology-intensive, utilitarian, low cost account that has already drawn thousands of previously unbanked Americans into the banking system. The ETA, as you know, allows recipients of many kinds of Federal direct-deposit payments to access their funds automatically through debit card-based electronic funds transfers.

Encouragingly, financial institutions are beginning to build on the ETA model, offering enhancements designed to make such accounts more useful and more widely available. Taking advantage of their ability to inexpensively batch remittances, some banks are beginning to develop ETA-like accounts that combine direct deposit with bill payment options. Such accounts are proving attractive to individuals accustomed to spending several dollars per month for money orders or electronic bill payments for that purpose. For banks, the key is to keep expenses down and paper to a minimum, and technology holds tremendous promise in that regard.

Keep in mind, too, that banks have some significant competitive advantages that should enable them to offer such accounts at reasonable prices. They alone have access to the payments system; they alone can hold transaction balances; they alone can receive direct deposits; they alone have deposit insurance coverage and access to the discount window. And they alone can offer services unique to banks in conjunction with a variety of other services.

Just think what such accounts offer. To the customer, they provide a safe and cheap repository for funds. No more lost or stolen checks; no more hassles to cash a payment check; no more risk of carrying around a wad of cash and becoming a target for predators. The paycheck goes directly into the bank account, and with a debit card the customer can draw funds as she needs them, at an ATM or point of sale. And if the bank has been innovative, the customer may even be able to make basic payments from the account by electronic transfer, either without cost or at a cost far less than a money order.

For the bank there are also important benefits: no processing of paper checks; no risk of overdrafts; establishing new customer relationships that may be developed into something more. For example, if such customers need small loans, for a car or appliance purchases -- or even a payday-type credit -- a direct deposit account offers the possibility of a prearranged debit or periodic payments, significantly reducing the bank's risk of default.

Banks are also taking the initiative to address the short-term borrowing needs of their customers, and here again, technology can be a big part of the solution. In one noteworthy development, a prominent national bank has begun to offer a product that provides access to low-cost cash advances for direct deposit customers. Funds can be obtained directly from the bank's ATM network or by speaking to a telephone agent who will transfer the funds into the customer's account. The bank has also automated the underwriting process, cutting costs for both parties to the transaction and virtually eliminating the waiting period for established customers -- a matter of considerable importance, as we've seen, for the emergency borrower.

Obviously there are many hurdles to be cleared before such innovations can be judged a success. We have to encourage greater participation in direct deposit. Direct deposit is one of those rare win-wins: employers enjoy significant savings in payroll processing costs; banks gain new business and retail customers; and employees avoid the worry and expense of handling paper checks.

Yet this is an area in which the United States has lagged well behind many other advanced nations -- and in which the private sector has lagged behind government. Today, as a result of the EFT 99 legislation, 77 percent of all government payments are made electronically. Seventy-five percent of Social Security payments are made by direct deposit and at agencies like the OCC, virtually 100 percent of salary payments are deposited directly.

One way we may be able to raise participation rates, as I've already mentioned, is to tie other useful products and services -- especially those that can be delivered electronically -- to direct deposit accounts.

If banks are to compete effectively against the storefront lenders and check cashers, they will also need to rethink their branching strategies and focus on refining their delivery systems and making them user-friendly. Some customers continue to report being deterred by what they view as an intimidating atmosphere in the typical branch, an objection that banks used to brush off when they could afford to be indifferent to the underbanked market. These days, banks seem to be taking such objections more seriously -- a development that may herald a new, more constructive attitude toward this market. Some institutions have acquired check cashing and payday lending outlets, where customers can select from the menu of financial products and services in the atmosphere they're accustomed to, while being gradually exposed to the potential benefits of mainstream banking.

Bringing more people, more fully, into the banking system must be a part of any strategy to improve the standard of living in our country. That's a goal I know we all share; it's the goal that has brought us to Baltimore this week.

The OCC is very proud to be the co-sponsor of this event, which holds tremendous promise for our communities and our financial institutions. For those of us in the financial regulatory community, lending assistance in the effort to build bridges to the underbanked is an important part of our official duties. For financial institutions, reaching out to new markets is not only a civic responsibility. It can also be a good business.