The Center for Financial Services Innovation
An Initiative of ShoreBank Advisory Services

July 2005

Marrying Financial Transactions with Asset-Building Opportunities

Introduction

Assets provide the foundation of economic well-being. Without appreciable assets, families are far more vulnerable to the strains of economic disruptions and are less likely to achieve financial prosperity. Unbanked and underbanked families are disproportionately represented among households without appreciable assets. Approximately 22 million, or 20%, of all U.S. households lack a bank account, while millions more have an account but also use a broad array of non-bank financial services to meet their needs. Without access to saving and investment vehicles, these households are further limited in their ability to achieve greater financial stability, acquire their own assets and build wealth.

One of the early innovations in promoting asset-building among underbanked consumers was the Individual Development Account (IDA), a matched savings account that rewards the monthly savings of lower-income, underbanked families who are building towards purchasing an asset – most commonly a first home, post-secondary education, or a small business. Since their inception in the 1990s, IDAs have gained significant acceptance among financial institutions, policy makers, and nonprofit organizations as important tools for promoting wealth among underbanked individuals and families, who generally do not qualify for other government wealth-building subsidies like the home mortgage interest deduction or the capital gains tax exclusion.

The positive results of IDAs show that, given the right incentives and access, underbanked consumers are willing to save and invest. The challenge now is to find ways to provide similar opportunities at scale. At the same time, the financial services industry is looking for new ways to leverage technology advances that make it faster and cheaper to move money in order to grow relationships with consumers beyond providing basic transactions. This issue brief describes the ways in which these two trends could converge to create new opportunities to link transactional financial services with asset-building opportunities.[1]

---

[1] This issue brief grew out of a meeting organized by CFSI in May 2005 that brought together leading IDA practitioners and private-sector innovators to share past experience and spark fresh thinking in how to link transactional products and services with asset-building features. The participants included Margaret Clancy, Center for Social Development, Washington University; Ed DeShields, Community Empower; Denise Fairchild, Community Development Technologies Center; Liz Handlin, NetSpend Corporation; Andrea Levere, CFED; Ben Mangan, EARN; Brandee McHale, Ford Foundation; Roy Sosa, NetSpend Corporation; and Jeff Zinsmeyer, D2D Fund.

2230 South Michigan Avenue, Suite 200, Chicago, IL 60616
312-881-5856 (Phone) 312-881-5801 (Fax) www.cfsinnovation.com

IDAs: What We've Learned about Building Assets and Changing Lives

IDAs represent one of the first attempts to create a vehicle for underbanked individuals and families to save and build assets. By rewarding participants with matching money added to their monthly savings, IDA programs promote home ownership, educational attainment and economic independence. The most recent tally identified more than 500 IDA initiatives in existence in communities across the country, with at least 15,000 people saving in IDAs.[2]

Though they vary in design and implementation, IDAs are dedicated savings accounts that match participants' contributions to the account. Participants have a strong incentive to save as their contributions are matched at very favorable ratios by government, philanthropic and private-sector institutions, typically between one and three dollars for every dollar that the participant contributes.

The programs have a cap on matching funds and a vesting period in which to earn them. The participants can withdraw their own funds before the vesting period is completed, but will lose the matching money. Participants can only withdraw the matching money for an asset purchase, such as paying for college, buying a home or starting their own business. While eligibility guidelines vary by program and by region, IDAs are generally available to those with household incomes below $35,000 a year. An additional component of IDA programs is financial education and counseling to help participants manage and repair their credit, set a budget and savings schedule, and prepare to purchase and manage an asset.

As individual IDA participants have succeeded in buying homes, starting businesses, going to college and saving for retirement, they have helped to prove that lower-income, underbanked families can and will save if given the appropriate access, ease and incentives. Within the American Dream Demonstration (ADD), a 13-site IDA demonstration that began in the late 1990s, participants accumulated an average of $700 per year including matches.[3] More importantly, as their savings increased, participants were more likely to achieve their monthly deposit targets, demonstrating that their saving behavior, like that of wealthier individuals, is influenced by the incentives they receive.

Financial institutions play a variety of roles in IDA programs, from providing the accounts to holding the pooled matching funds, to providing financial coaching and making financial contributions. IDA-sponsoring institutions are overwhelmingly commercial banks and thrifts (81%), with credit unions making up the remaining total (19%).[4] Citigroup, Bank of America and others have been at the forefront, serving as depositories for IDAs and providing matching funds. Most financial institutions support IDA programs in the spirit of community development. However, according to a recent survey, 45% consider IDAs an investment in

[2] A Look at the Growing Individual Development Account Field, Results from the 2003 Survey of IDA Programs, CFED, Washington D.C. An earlier survey found 20,000 accounts. The discrepancy is likely due to participants completing the program and making an asset purchase, thus closing their IDA account.
[3] Financial Institutions and IDAs: Results of a National Survey; Center for Community Capitalism, The Frank Hawkins Kenan Institute of Private Enterprise, The University of North Carolina at Chapel Hill, October 2003
[4] Ibid

developing and expanding their markets. These institutions recognize the benefit from acquiring new customers who can eventually utilize other banking services, such as mortgages and lines of credit. Considering that the combined unbanked and subprime credit population may include 30 million to 40 million households who spend at least 2% of their income on basic financial services, this untapped market could be worth $4 billion to $9 billion in revenues.

While the IDA field has generated significant success and learning, it continues to search for the right model for building scale. The experience of IDA programs to date indicates that the ability to build a scalable, sustainable model depends on several factors:

- The financial counseling component of the IDA program is believed by many to be as critical as the matching funds. Providing financial education and advice is seen as essential to helping at least some IDA participants reach their savings goals and keeping early withdrawals to a minimum. But aside from a handful of experiments around less costly, web-based delivery methods, no one has figured out how to provide the financial education component at scale.

- IDA participants display varying financial behaviors and preferences, just as higher-income consumers do. However, most early IDA programs took a one-size-fits-all approach. Today, more sophisticated IDA programs attempt to segment their customers and tailor their services accordingly, which in turn improves efficiency and reduces costs.[5] The need to better segment lower-income customers extends to designing and delivering a full range of viable financial products and services.

- According to the research, the savings amassed by IDA participants comes from a variety of sources. While reduced consumption is one source, another important source is tax refunds and other public benefits. In fact, many families explicitly over-withhold as a forced savings opportunity. Leveraging non-traditional cash flows can enable families to save and invest in more traditional financial vehicles.

- Partnerships between financial institutions and nonprofit organizations are critical, but greater clarity is needed around the roles that each is best suited to play. In most IDA programs, non-profit agencies not only market the program, enroll customers and provide financial advice, but they also manage the databases that track saving levels and the corresponding matching funds.

Alternative Models: Implications for the Future

As the IDA field searches for ways to provide incentive-based savings opportunities to the masses, the revolution in electronic payments is creating vast new possibilities for linking saving and investment opportunities to transactional products, by bundling multiple functions

[5] One early innovator in segmenting IDA customers is the San Francisco Earned Assets Resource Network, or EARN. The group, which runs a citywide IDA program, has identified at least three different clusters of IDA consumers based on the level of one-on-one interaction and financial counseling they require.

in one product and making consumers' financial lives truly seamless. By leveraging these transactional platforms, financial services companies can build deeper relationships and loyalty with their customers by filling a broader range of needs in a convenient, customer-centric way. A handful of approaches are already showing real promise:

Refund Splitting: There is a growing recognition that tax time is a powerful moment for many underbanked consumers. Federal tax refunds to low-income families totaled over $78 billion in 2001. Approximately 20 million Americans claim nearly $40 billion annually through the Earned Income Tax Credit (EITC). For many families, tax refunds are the single largest lump sum of cash received each year, offering an ideal opportunity to consider saving and investment possibilities.

One of the most promising strategies to promote increased personal saving – particularly for lower income working families – is to facilitate the direct deposit of tax refunds into IRAs, 529 college savings accounts, and other savings vehicles by allowing taxpayers to split their refunds. Refund splitting allows taxpayers the option to send their refund to two or more different accounts, opening the possibility that a portion of the refund could go to a transaction account and a portion could be sent to a savings vehicle.

In 2003, a nonprofit organization called Doorways to Dreams (D2D) designed the Refunds to Assets (R2A) pilot to test federal tax refund splitting on a small scale. Working with its partners, the Community Action Project of Tulsa County (CAPTC) and the Bank of Oklahoma, D2D pioneered a "bifurcation tool" which permitted taxpayers the option to automatically pre-commit a portion of their refund to a savings account or, if they owned a home, to a mortgage prepayment. During the 2004 tax season, 500 people were offered the opportunity to split their refunds, directing part to savings and part to cash for spending. Twenty-seven percent elected to split their refund. Follow-up surveys indicated 95% of these participants would use this option again.

After years of consideration, the IRS recently committed to a refund splitting program in 2007. To accommodate this enhancement, tax forms are being redesigned to accommodate multiple accounts along with designated percentages for the tax payers refunds. This presents promising marketing opportunities for financial institutions.

Stored Value Cards Stored value cards (SVCs), a relatively new payment product that serves as a cash or check alternative, are becoming ubiquitous throughout the U.S. as the segment continues to grow and evolve. Like traditional debit cards, stored value cards (SVCs) utilize magnetic stripe technology to store information and track funds. However, because they are prepaid, SVCs differ from traditional account-based debit cards in that they have limited risk of overdrafts while providing nearly immediate liquidity for consumers.

Merchant gift cards, prepaid telephone cards, payroll cards, and government benefit cards are just some of the variations of SVCs. According to industry estimates, more than 2,000 stored value programs are available, with roughly 7 million Visa- or MasterCard-branded stored value cards in the marketplace. There are approximately 20 million users and that figure is expected to more than double to 49 million users by 2008. In 2003, stored value cards were used to make $42 billion in transactions. By 2006 stored value transactions are expected to reach over $72 billion.[6]

The convenience and ease of obtaining a SVC has made this a potential alternative to checking accounts, especially for the underbanked. Consumers not only can use these cards to make payments to a wide variety of merchants and service providers but also can reload them with additional funds. By linking Individual Development Accounts or refund splitting to stored value cards, consumers could benefit with more asset-building opportunities and credit-building functionality.

One of the largest SVC providers in the U.S. recently launched a savings feature that provides a glimpse of the potential synergies between SVCs and IDAs. NetSpend is an Austin, Texas-based marketer and processor of prepaid and stored value cards that was launched in 1999 by brothers Roy and Bertrand Sosa. Today, the company is one of the largest SVC providers with more than 700,000 cardholders, and in the past year, customers have loaded in excess of $1 billion in funds onto NetSpend cards. NetSpend's SVCs are distributed primarily through check cashing outlets and grocery stores.

In an attempt to meet the savings needs of its customers, in May 2005 NetSpend launched the All-Access National Savings Program. Through the program, accountholders can move funds into interest-bearing savings accounts by transferring money through their prepaid debit cards. The savings accounts, which are held at Inter National Bank in Texas, pay interest similar to that paid to traditional savings accounts. Cardholders have the option of making one-time transfers to savings or setting up automatic, recurring transfers that move a fixed dollar amount from the card account to the savings account whenever a load is made to the card. Enrollment in the program is free, and there are no fees for maintenance or transfers. Customers would still have to pay to withdraw money, however.

In the second half of 2005, NetSpend plans to actively court partners to provide matching funds for the savings product. According to company representatives, matching funds are very important to the future of the savings product. NetSpend also plans to work with partner agencies to incorporate more financial education services into its marketing materials and website to promote long-term financial planning.

Reward Programs Reward programs, which offer incentives to consumers on the basis of cumulative purchases of specific products or services, have become a popular tactic in the quest for customer loyalty. Examples include frequent flyer programs, cash-back credit cards and merchant rebates. According to a recent study conducted by Financial Research Corporation, merchant and credit card rebates have the potential to represent an incremental $1.1 billion per year in assets to banks and investment management firms by 2005.[7]

---

[6] Stored Value Cards: An Alternative for the Unbanked. Federal Reserve Bank of New York, 2004. http://www.ny.frb.org/regional/stored_value_cards.html
[7] Financial Research Corporation. For more information, contact 617-824-1314.

While most of these programs reward consumption with more consumption, some companies are rewarding consumption with saving and investing opportunities. Companies such as Upromise and BabyMint have leveraged this concept by providing families with an easy way to save for college by investing their cash rewards on a regular basis. Families sign up for the free service to receive rebates on their qualified spending from participating retailers, grocers, restaurants and other service providers. Program providers track, collect and deposit the earnings into the participants' tax-free 529 college savings plans.

Over the five-year period from 1999 to 2003, assets in these 529 savings plans grew from $1 billion to $35 billion.[8] These figures have captured the attention of fund companies looking to expand their markets and enhance profitability. The infrastructure of these rewards programs could be expanded to link to IDAs, new savings vehicles that could be used for buying a home, or other uses.

Another successful innovation in rewarding savings is lottery-linked deposit accounts.[9] In South Africa, First National Bank offers a "Million-a-Month" account. This deposit account does not earn interest but is linked to a lottery with guaranteed prize money. Participants need a minimum opening deposit and account balance of R100 (approximately $16 U.S.) to be entered into the monthly drawing, with each R100 invested representing one entry into the drawing. Similar programs have had success in Bangladesh, Mexico, Colombia, Venezuela, and Argentina. While state-run lotteries in the U.S. are far more heavily regulated – and draw greater ire from consumer advocates – these international examples suggest that the power of lotteries to influence behavior can be harnessed for the good of consumers and institutions alike.

Moving Forward: Key Issues to Consider

The range of design and creativity displayed in cutting-edge transactional products suggests a myriad of ways to link them with longer-term saving and investment opportunities that enable lower-income families to jump-start their financial futures. Realizing the potential synergies, however, will require new approaches:

- In the past, banks were the primary outlet for obtaining basic financial services. The financial services landscape is changing, however, and the traditional linear model of asset building progression, sometimes described as the Credit Path,[10] does not necessarily reflect the complex reality of a multifunctional and increasingly seamless financial transactions environment. Institutions like NetSpend represent a new breed of financial intermediary that suggests alternate pathways that consumers can take on the road to assets.

[8] Ibid
[9] Banking on Gambling: Banks and Lottery-Linked Deposit Accounts, Mauro F. Guillen, Adrian E. Tschboegh, The Wharton School, University of Pennsylvania, May 2001
[10] The Credit Path, developed by Alternatives Federal Credit Union in Ithaca, NY, is a framework for contemplating how consumers achieve financial prosperity as they progress from transactors, to savers, to borrowers and ultimately to owners.

- Banks have pursued credit opportunities (primarily mortgages) for lower-income families, in large part because of the focus of the Community Reinvestment Act, and have overlooked the corresponding saving and investment opportunities. While bankers across the country have come to recognize the profit potential of making mortgages in lower-income communities, the lack of cross-divisional communication in financial institutions has made them ineffective champions for implementing a broader array of financial services. Connecting both sides of the bank is critical to catalyzing new thinking and new strategies.

- A critical issue is how to seize the opportunity of the IRS expanding the option of splitting tax refunds. Given the positive results of the R2A pilot and the intention of the IRS to offer refund splitting beginning in 2007, this may be the most immediate and tangible opportunity for scale. The potential for a huge influx of investment capital should capture the interest of the private and nonprofit sector. In preparing for this event, it is crucial that the topic of asset-building for lower-income families be brought to the forefront of public dialogue.

Conclusion

Dramatic changes in the financial services landscape are presenting new opportunities for providing lower-income, underbanked consumers with the chance to save and invest. IDAs dispel the myth that this consumer segment can't save and provide significant lessons around product design and delivery. Linking these lessons with private-sector innovation could spark fresh thinking and lead to the next round of innovative offerings.

The Center for Financial Services Innovation
An Initiative of ShoreBank Advisory Services

To Contact CFSI

2230 South Michigan Avenue
Suite 200
Chicago, IL 60616

312-881-5856 (Phone)
312-881-5801 (Fax)

info@cfsinnovation.com
www.cfsinnovation.com

The Center for Financial Services Innovation (CFSI), an initiative of ShoreBank Advisory Services with support from the Ford Foundation, was founded in 2004 to encourage the financial services industry's efforts to serve un- and underbanked consumers. The Center provides funding for innovative solutions, a meeting place for interested parties and resources for testing products and services. CFSI also identifies, develops and distributes authoritative information on how to respond to the needs of the underbanked profitably and responsibly. CFSI works with banks, credit unions, technology vendors, alternative service providers, consumer advocates and policy makers to forge new relationships and pioneer products and strategies as it seeks asset-building opportunities that create value for both customers and companies. For more on CFSI, go to *www.cfsinnovation.com*

ShoreBank is America's first and leading community development and environmental banking corporation. ShoreBank Advisory Services is its research and consulting arm. For more on ShoreBank, go to www.shorebankcorp.com.

SHOREBANK
Let's change the world.℠