Estimating the Cost of Being Unbanked

Illustration by Joe Guidry

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A surprising number of people do not use banks, and it can cost them. Estimates of U.S. households lacking a formal banking affiliation with a federally insured depository institution run from 10 percent and 25 percent. The people in these households, the "unbanked," resort to alternative financial-service providers, retail outlets such as groceries and convenience stores, and banks where they hold no account but make use of services such as check cashing and bill payment.

Several studies have attempted to understand these individuals and examine what costs they incur by not having a checking or savings account. Clearly, policy aimed at bringing formal financial services to the unbanked (such as the Department of Treasury's recent effort to promote special accounts for direct deposit of government checks, electronic transfer accounts) hinges on these cost-accounting exercises. The unbanked will benefit from having an account only if the costs of not having one are greater than the costs of having one. A better understanding of the direct and indirect costs is key to helping this population.

Characteristics of the Unbanked

Virtually all studies show that, compared with people who have bank accounts, the unbanked have below average income and education, are younger, more likely to reside in urban areas, and disproportionately nonwhite.[1] Though a relatively homogeneous group, the individual members give varied reasons for not having accounts—they dislike banks, they lack proper identification for opening an account, they prefer the convenient hours of alternative financial services, they like the privacy of keeping money at home.[2]

But people's primary justifications for remaining unbanked relate to their income and the perceived cost of bank accounts.[3] Many individuals weigh the costs of being banked (monthly fees, minimum balance requirements, and possible overdraft charges) against the costs of being unbanked and decide in favor of the latter. But are they able to correctly identify the full spectrum of costs? Organizations interested in helping this population need to know the answer.

Direct Costs

Direct costs of being unbanked (costs that are clearly quantifiable and immediate) consist primarily of the fees associated with basic banking services such as check cashing and bill payment. Most studies combine fees related to check cashing and money orders (for bill payment) to estimate direct costs. In calculating the cost of cashing checks, it is important to separate government and payroll checks from personal checks as the fees are often different. Check cashing outlets, termed neighborhood financial-service centers, tend to charge the most for check cashing services. The fee for personal checks can be as high as 10 percent of face value while government or payroll checks cost up to 1.5 percent of face value.[4] Banks and credit unions may also cash checks for people who do not hold accounts, typically at a much lower price.[5]

Money orders purchased for bill payment are somewhat more uniform in

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Researcher	Monthly Cost	Yearly Cost	Costs the Researcher Accounted For
Edward S. Prescott (1999)	$2.50	$30	Money orders (checks cashed for free)
Joseph J. Doyle (1999)*	$14.33	$172	Check cashing fees (one payroll check per month)
Michael S. Barr (2004)	$20.83	$250	Check cashing fees (one payroll check per month)
Barbara A. Good (1999)	$26.50	$318	Check cashing fees (one government, two personal checks) Three money orders

* Joseph J. Doyle, et al., "How Effective is Lifeline Banking in Assisting the 'Unbanked'?" *Federal Reserve Bank of New York Current Issues in Economics and Finance* 4, no. 6 (June 1999).

terms of cost. They are sold in retail outlets, neighborhood financial-service centers, banks, and the like and have fees ranging from less than $0.40 to slightly more than $1. Businesses such as grocery stores often discount the price of money orders to attract cash-only customers.

The direct cost of being unbanked can vary from relatively low to extremely high, depending on how many money orders individuals purchase, how many checks they cash, what sort of checks they are, and where they cash them. (See the exhibit "Estimated Cost of Being Unbanked.")

Indirect Costs

Indirect costs are less tangible than direct costs, partly because they are likely to be incurred at a point in the future. Since estimates of direct cost vary so widely, they are inconclusive in determining whether a formal banking relationship would benefit the unbanked. Therefore policymakers and economists should include less tangible costs when assessing the value of bank accounts to the unbanked. The most important indirect costs relate to people being less able to save or build a credit history.

Though having a bank account does not necessarily mean an individual will save, many of the unbanked themselves say that it is "important" in facilitating saving. Formal saving is positively correlated with critical asset-building behavior. Individuals who save in a savings account are more likely to have other types of financial accounts, such as certificates of deposit and insurance contracts. They are more likely to own homes and cars, and they are also more likely to use formal sources of credit.

Unbanked individuals, however, are forced to use other methods if they wish to save. Keeping cash or jewelry at home is one example, but such methods offer no interest and leave individuals more susceptible to theft.[6]

Additionally, the unbanked miss the benefits that a bank account offers for building a credit history. Credit histories can legally be used not only for loan decisions but also for employment and housing decisions.[7] When initiating a loan, individuals with a credit history are more likely to have access to bank loans or other formal sources of credit.[8] Unbanked individuals frequently lack sufficient credit histories to satisfy the requirements of traditional lenders and are often obliged to resort to high-interest, informal loan products. These expensive loans can easily balloon out of control, at times becoming more costly than their initial value.[9]

When someone gives up the asset-building benefits associated with having a bank account, indirect costs increase.

Effective Policies

Direct and indirect costs of being unbanked, when examined together, may help organizations determine the efficacy of their programming. To ensure that policy is both effective and well targeted, both types of costs need to be accounted for. Organizations attempting to bank the unbanked should consider not only the direct costs of being unbanked but also the less easily measured indirect costs. Direct-cost estimates should be based on the costs of check cashing and bill payment, and indirect costs should be an estimate (however imperfect) of the lifetime costs related to forgone asset building. When taken together, these estimates will be valuable in designing programs such as banking outreach and account provision.

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Endnotes

1 Ellen Seidman et al., "A Financial Services Survey of Low- and Moderate- Income Households," The Center for Financial Services Innovation, July 2005. See also Federal Reserve Bank of St. Louis, "Understanding the Dependence on Paper Checks," July 2004. (http://fms.treas.gov/eft/reports/EFTResearch 7.27.04FINAL.pdf).

2 See Seidman, "A Financial Survey," 2005, and Dove Associates, Inc., "ETA Conjoint Research: Final Report and Market Model, Unbanked Federal Check Recipients," OMB #1510-00-71, Washington: U.S. Department of the Treasury, May 26, 1999.

3 Bucks 2006, Seidman 2005, FRB St. Louis 2004, and Prescott 1999 all say this.

4 Barbara A. Good, "Bringing the Unbanked Onboard," *Economic Commentary*, Federal Reserve Bank of Cleveland, issue Jan 15, 1999.

5 Edward S. Prescott and Daniel D. Tatar, "Means of Payment, the Unbanked, and EFT '99," Federal Reserve Bank of Richmond, *Economic Quarterly* 85, no. 4 (fall 1999): 49-70.

6 Anne Stuhldreher and Jennifer Tescher, "Breaking the Savings Barrier: How the Federal Government Can Build an Inclusive Financial System" (Washington, D.C.: New America Foundation, February 2005).

7 See Fair Credit Reporting Act, Section 604.

8 Michael Barr, "Banking the Poor: Policies to Bring Low-Income Americans into the Financial Mainstream" (Washington, D.C.: Brookings Institution, 2004).

9 Payday advance loans, for example, often charge between 213 percent and 913 percent annually. Credit cards offer comparable lending services to those who have a normal credit history at an average rate of 11.5 percent. See Brian Bucks, Arthur Kennickell, and Kevin Moore, "Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances," *Federal Reserve Bulletin* 92 (February 2006): A1-A38.