POLICY BRIEF

CENTER FOR THE NEW ECONOMY

CENTRO PARA LA NUEVA ECONOMIA

Channeling People Into the Economic Mainstream: Financial Access in Puerto Rico

Executive Summary

A significant segment of the Puerto Rican population, 36%, is unbanked. These households tend to be extremely poor, with an average income of $8,472, and headed by older single unemployed females with a less than average education. Close to 50% of all unbanked households are located in the greater San Juan area.

This lack of financial access precludes unbanked households from enjoying benefits associated with asset accumulation which exist *in addition* to the benefits conferred by the ability to defer consumption and creates a major obstacle for the implementation of asset-based policies to reduce poverty in Puerto Rico.

Recent research shows that assets have significant positive non-economic effects on children, families, and neighborhoods. In general, there is growing evidence that assets are associated with greater household stability, higher educational attainment, local civic involvement and increased levels of health and satisfaction among adults. Assets are also associated with decreases in both marital dissolution and intergenerational poverty transmission. Consequently, a large unbanked population is an impediment for the implementation of asset building policies, which, in turn, dilutes efforts aimed at reducing poverty in Puerto Rico. Therefore, reducing the number of unbanked persons should be a primary objective of social welfare and economic development policies.

In this paper we offer suggestions order to increase financial access and reduce poverty in Puerto Rico that are based on an analysis of innovative proposals and which constitute, in a sense, a synthesis of what could be called the "best practices" to reach the unbanked. In terms of financial products we discuss:

- Beginner accounts;
- Stored Value Cards; and
- Individual Development Accounts.

In the final section we offer a set of recommendations for local policymakers to help increase financial access in Puerto Rico. On the policy side, we analyze the following:

- Implementation of Direct Deposit for Government Employees;
- Changing the Mode of Paying Benefits Under Government Programs;
- Providing a Subsidy to Financial Institutions Offering Beginner Accounts;
- Revising Asset Limits in Social Welfare Programs;
- Offering a Tax Credit to Financial Institutions that Match IDA Deposits; and
- Funding Research to Yield Better Information about the Unbanked Population in Puerto Rico.

In the final analysis, at the dawn of the 21st century it is difficult to explain why 36% of the population of Puerto Rico, which has one of the most competitive financial service sectors in the world, does not have access to a bank account. It is clear the low-income and unbanked sectors present a growth opportunity to financial institutions in Puerto Rico. In addition, improving financial access would be a significant step in eliminating other forms of social exclusion. Financial institutions, in other words, can be of assistance in creating social structures which expand the set of opportunities and possibilities available for individual action in Puerto Rico, while selling profitable new products at the same time.

Introduction

In the 21st century, having access to a basic bank account has been compared to securing access to reliable "electricity, running water and telephone service."[1] Other commentators have gone further to declare that having access to financial services is "critical to success in the American economy."[2] Yet in Puerto Rico, where we have one of the most advanced financial systems in the world, fully 36% of households did not have a checking or savings account.[3] These households are marginalized from the financial system and essentially operate in a segregated, cash economy. In addition, over 75% of these households reported income below the federal poverty threshold for that year. Accordingly, when we refer to the "unbanked" population in Puerto Rico we are using short hand to describe some 454,000 extremely poor households.

These unbanked families must pay considerable costs for basic financial services and face enormous difficulties in accumulating savings for emergencies or to weather a temporary fluctuation in income due to, for example, sudden illness or divorce. The unbanked are also by and large cut off from traditional sources of credit either for short-term consumption or for home ownership because these persons cannot convey key financial information which banks need to evaluate in order to assess credit risk and comply with their credit guidelines.

However, the detrimental effects associated with lack of access to financial services go beyond the economic cost charged by check cashing companies and small loan companies or the social costs associated with the lack of savings for a "rainy day" or for the downpayment on a house. First, the widespread lack of access to financial services also prevents these unbanked households from enjoying those benefits associated with asset accumulation which exist *in addition* to the benefits conferred by the ability to defer consumption for an emergency situation, namely, higher levels of family stability and educational attainment.

In addition, the existence of a significant unbanked sector of the population is a major obstacle for the implementation of innovative, asset-based policy initiatives to reduce poverty in Puerto Rico, where, according to the 2000 Census, 48.2% of individuals lived with incomes below the federal poverty threshold.

Poverty, needless to say, is a complicated phenomenon, the product of an interlocking set of circumstances – cultural, economic, institutional, personal, political and social – which, according to Amartya Sen, result in the deprivation of those capabilities that individuals need to develop in order to participate effectively in economic and social life.[4] In Puerto Rico, as in the United States, the emphasis of antipoverty policy has centered largely on providing income support for consumption by the poor. However, this approach is increasingly considered deficient for a number of reasons. First, research shows that income transfers for the poor do not reduce pre-transfer poverty. That is, though income transfers have helped to ease immediate hardship, in many cases they have not allowed families to escape from poverty in the long term.

Second, even if income transfers were entirely successful in eliminating the short term effects of poverty, they are an inadequate instrument for addressing the long term lack of capabilities to

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[1] Michael A. Stegman, "Banking the Unbanked: The Untapped Market Opportunities for North Carolina's Financial Institutions", *North Carolina Banking Institute Journal*, Vol. 5, 2001, p.23.
[2] Michael S. Barr, "Banking the Poor", *Yale Journal on Regulation*, Vol. 21, Number 1 (Winter 2004), p.123.
[3] BPPR data, 2002
[4] Amartya Sen, *Development as Freedom*, (New York: Anchor Books, 1999) p. 75.

meaningfully enjoy the freedoms afforded by a democratic capitalist society. If the effects of poverty are described as a deprivation of capabilities to build social, human and financial capital, then relying solely on a policy of income transfers, as important and necessary as such transfers may be, to support consumption today is not particularly effective as a long term antipoverty strategy. The problem, stated in simple terms in the words of Michael Sherraden, is that "very few people manage to spend their way out of poverty."[5]

In this context, it becomes clear that if we want to achieve a significant reduction in poverty rates over the long term, it is necessary to develop alternative antipoverty policies that focus on the development of individual capabilities. Promoting asset building is one policy pathway to increasing individual capabilities.

The success of asset-based anti-poverty policies, however, requires the development of institutions that can bridge the gap between the informal social relations of the poor and the official world of finance. As Mark Stern has demonstrated, there exists a split between the interests of social policy and the real lives of the poor. On the one hand, the poor have found ways to develop survival strategies, despite the limitations imposed by their economic, social and political exclusion. Yet the institutions through which they must operate – welfare bureaucracies, financial services providers and nonprofit organizations – traditionally are not connected to this informal world.[6]

In the world of financial services, the existence of this gap between the formal and the informal is demonstrated by the fact that most poor families do not even have a basic link with a formal provider of financial services. This gap exists due to flaws in both the demand and the supply of financial services to the poor. Simply stated, the problem is that, while the poor may intuitively know how to reach the bankers and the bankers may be aware of the existence of a huge population without access to transactional accounts, cultural, legal, institutional and social barriers hinder the efforts of each group to connect with the other. In addition, neither group perceives an economic interest in trying to reach the other, although those interests exist.[7]

Thus, while the conventional financial system works extremely well for most Puerto Ricans, more than one third of our families, including many low income families, have little or no contact with formal providers of financial services. This situation makes it extremely difficult for these persons to invest, save and accumulate assets.

We can begin to address this breakdown in the market for financial services in two ways:

- On the demand side, programs can be designed to help the poor establish "financial contact" in ways often unknown to traditional bankers by providing information and education in the very basics of using financial institutions.
- On the supply side, we can provide incentives to financial institutions for crafting products specifically designed to attract the poor, serve their needs and acculturate them to using these services on a regular basis.[8]

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[5] Michael Sherraden, *Assets and the Poor: A New American Welfare Policy*, (New York: M.E. Sharpe, Inc., 1991) p.7.
[6] Mark J. Stern, "The Un(credit)worthy Poor: Historical Perspectives on Policies to Expand Assets and Credit" in *Assets for the Poor: The Benefits of Spreading Asset Ownership*, Thomas M. Shapiro and Edward N. Wolf, eds., (Russell Sage Foundation: New York, 2001) p.269.
[7] Robert Cornell, *Asset Building and the Escape from Poverty: A New Welfare Policy Debate*, paper published by the Local Economic and Employment Development Program of the Organisation for Economic Co-Operation and Development, p. 11.
[8] Id.

This paper seeks to address the breakdown of the financial services market in Puerto Rico from the perspective of the supply side. This is an area where significant work remains to be done because, while a financial institution's recurring monthly costs for administering a low-income account can likely be covered by low monthly fees charged to consumers, at this early stage in the evolution of research and development for low income products, banks' upfront costs are likely to exceed what most unbanked households are willing to pay. Therefore, financial institutions may be reluctant to expend resources for research, product development, training, marketing and education, which are necessary to expand financial services to a lower-income clientele. In specific, we will examine what products can be developed to target this population and what policies can be implemented by the government to actively increase access to financial services in Puerto Rico.

In summary, there exists a large segment of the population in Puerto Rico that does not have access to financial services. This situation makes it extremely difficult for these households to save and enjoy those benefits associated with asset accumulation. In addition, a large unbanked population is an impediment for the implementation of asset building policies, which, in turn, dilutes efforts aimed at reducing poverty in Puerto Rico. Thus, reducing the number of unbanked persons should be a primary objective of social welfare and economic development policies.

Snapshot of the Unbanked Population in Puerto Rico

According to a study conducted in 2002 for Banco Popular de Puerto Rico, approximately 454,000 households in Puerto Rico, 36% of all Puerto Rican households, did not have a bank transaction account.[9] Most of these households are low-income—the average income of unbanked households was $8,472—and 77% of them reported earnings of less than $15,000 per year. Nearly all of these households are also extremely poor, given that in 2002 the federal poverty threshold for a family of three (the average size of unbanked households in Puerto Rico) was $14,494. Thus, the average unbanked household in Puerto Rico lived on an annual income equal to 58% of the applicable federal poverty threshold.

In addition, the study found that the person in charge of paying the bills in unbanked households tends to be:

- Older, with an average age of 52 years;
- Female, head of household in 72% of the cases;
- Single (including separated, divorced or widowed), 54% were not married;
- Less educated than the average Puerto Rican, 61% had less than a high school education while the 2000 Census indicates that 60% of all Puerto Ricans over 25 were at least high school graduates;
- Unemployed, 79% of them did not work; and
- A resident of the greater San Juan area, fully 46% of them lived either in the San Juan metropolitan area or in the suburbs of San Juan.

In 2002, 39% of unbanked households reported that at least one member of the household was working; while 61% of such households reported that no household member had formal employment. Of the 39% of unbanked households that reported at least one family member to

[9] The term "unbanked" in this paper refers to individuals who did not have a transaction account (no checking account, savings account, or Christmas club account) at a depository institution, whether at a bank or at a credit union.

be working, 89% worked outside the home and a significant majority of these workers, 63%, were paid with checks.

Of those unbanked households that received checks from non-government sources, 67% cashed them at financial institutions, mostly at banks (59%), followed by credit unions (7%) and small consumer loan companies (*financieras)* (2%); 17% cashed them at stores, mostly convenience stores (13%); and 16% cashed them at other sites, including check cashing outlets (8%). The overwhelming majority (85%) of these establishments did not charge a fee for cashing such checks. Among the 15% that did charge a fee, the average fee was $3.52. Check cashing outlets were the most likely to charge a fee for cashing private checks.

Income from government sources, mainly PAN and Social Security, constituted the main sources of income for the overwhelming majority of unbanked households in Puerto Rico. Eighty percent (80%) of unbanked households received income from at least one government source.

This profile, while providing cause for concern, is not, however, uniformly bleak. First, it is worthy of note that 85% of the establishments that cashed checks for the unbanked in Puerto Rico provided this service free of charge. The Puerto Rican unbanked, thus, seem to have avoided paying the exceptionally high fees that are commonly paid by unbanked customers for cashing checks in the United States. Ironically, the low incidence of check-cashing fees may create a financial disincentive for opening a regular bank account in a financial institution because the "liquidity premium" associated with being unbanked is low or, in many cases, zero. If a person can cash her payroll or government benefit checks for free, why would she open a bank account which is subject to all sorts of terms and conditions, such as minimum balances, overdraft penalties, transaction fees, etc? This is an area that definitely deserves further investigation in Puerto Rico.

Second, the number of respondents indicating they did not trust banks or that banks were difficult to reach was very low. These results suggest that cultural or geographical factors are not significant explanatory reasons for not having a checking or savings account in Puerto Rico. Furthermore, the data indicates that a majority of the unbanked population has been actively using financial institutions (banks, credit unions and *financieras*) to cash their checks. This would indicate that the levels of cultural apprehension about and mistrust of financial institutions are relatively low. Similarly, the high frequency of the use of financial institutions for cashing checks is indicative of relatively broad geographic accessibility

Finally, the willingness to use banks for cashing checks suggests that lack of account ownership is not due, at least not primarily, to consumer ignorance of available options, after all, many of the unbanked in Puerto Rico transact with banks or credit unions on a monthly basis, many had had a banking relationship in the past and a small portion of them have a credit relationship with a financial institution. This finding is consistent with recent research which reveals that the banked/unbanked dichotomy that underlies the popular understanding of this problem may miss the subtleties of consumer behavior. It appears that it is fairly common for households to have one foot in the formal financial sector and one foot in the alternative financial sector. The "unbanked" thus are not a monolithic group, but rather a collection of somewhat overlapping, yet diverse, groups with different needs. Understanding the needs of these groups is the key to the successful delivery of financial services.

Developments in the Financial Services Market

During the 1990s, the market for financial services underwent profound changes. First and foremost among these were the technological advances in the delivery of financial services. According to Stegman, these developments included "the rise of electronic banking, in-store branching, fee-based banking, and the increasing use of customer profitability analysis to customize products and segment the market."[10] Other important technological developments, include the proliferation of ATMs, many with increased functionality, direct deposit, on-line banking, and "most recently, all types of electronic, card-based products [which] have brought down the cost of serving the retail banking customer and carry the promise of ever-greater efficiencies." [11]

This period also witnessed the implementation of several initiatives by federal and state governments to increase access to the financial system. These included the direct deposit via electronic funds transfer (EFT) of federal benefits for social security recipients, the implementation of Electronic Transfer Accounts (ETAs) by the U.S. Treasury, and the increased delivery of social welfare benefits at the state level via electronic benefit transfer (EBT).

The securitization of financial assets and the emergence of a broad market for asset-backed securities is another important development during this period. This development effectively reduced the working capital required to operate in the financial services industry because both the credit and the market risk associated with making long-term loans can be transferred from the lender to third-party bondholders. Securitization also reduced the demand for certain corporate banking products and services as investment bankers became more aggressive in marketing their services to corporate clients which found issuing asset-backed securities an attractive alternative to traditional borrowing. As a consequence, commercial banks were forced to refocus on individual banking. Finally, securitization, in tandem with technological advances, has encouraged the entry to the financial services industry of asset-management firms that operate and manage all sorts of mutual funds. These firms compete with commercial banks for deposits.[12]

The 1990s also witnessed the explosion of the alternative financial services sector. In the United States, "the number of payday lending stores grew from a few hundred outlets in the mid-1990s to over 10,000 by the year 2000"; while the number of pawnshops increased from about 4,800 in 1986 to over 11,600 in 2003.[13]

Finally, the last decade of the 20th century saw the rise and expansion of the individual development account (IDA) movement. IDAs are restricted savings accounts that working people who are poor can use for purchasing a home, pursuing higher education or vocational training or starting a small business enterprise. A key feature of these accounts is that private or public partners match, dollar for dollar in most cases, deposits made by individual account holders. According to Stegman, IDA programs "are an effort to democratize tax-driven savings policies by creating direct incentives that are more effective in helping low-income, low-tax bracket households than IRAs and similar programs".[14] By 2003, the number of IDAs outstanding in the United States was estimated to be between 20,000 and 50,000.[15]

The financial services sector in Puerto Rico was not immune to these developments and manifestations of all of them could be detected in greater or lesser degree across the financial services industry. First, the impact of technology has perhaps been the single most important

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[10] Michael A. Stegman, *Savings for the Poor: The Hidden Benefits of Electronic Banking*, (Washington, DC: Brookings Institution Press, 1999) p.40.

[11] Ellen Seidman and Jennifer Tescher, *From Unbanked to Homeowner: Improving the Supply of Financial Services for Low-Income, Low-Asset Customers*, Joint Center for Housing Studies, Working Paper Series, paper BABC 04-4, (Cambridge, MA: Harvard Graduate School of Design and the John F. Kennedy School of Government, February 2004) p. 6.

[12] Estudios Técnicos, *Movimiento Cooperativo: Hacia una Visión Estratégica*, 16 Abril 1996, p. 54.

[13] Seidman and Tescher, *From Unbanked to Homeowner*, *supra* note 11 at 7.

[14] Stegman, *Savings for the Poor*, *supra* note 10 at 129.

[15] Seidman and Tescher, *From Unbanked to Homeowner*, *supra* note 11 at 7-8.

factor driving the growth and evolution of the local financial services industry. According to a recent presentation by Richard L. Carrión, chairman and chief executive officer of Popular, Inc., the largest financial services company in Puerto Rico and ranked 31st in the United States, in 2003, sixty-three percent (63%) of all transactions processed by Popular were initiated electronically while 37% were paper-based. Popular expects the ratio of electronic to paper transactions to be around 93% to 7% by the year 2010.[16]

Popular has also led the way in rolling out ATM and POS terminals in Puerto Rico and in providing telephone access to accounts. In 1983 Popular operated 30 ATMs, twenty years later, its ATM network in Puerto Rico consists of 1,300 ATMs with a transaction volume in excess of 9,000,000 transactions per month.

In terms of POS terminals, Popular operates 40,000 terminals across the island, with total transaction volume of approximately 10,000,000 transactions per month. In terms of telephone access, Popular's telebanking line receives approximately 3,000,000 calls per month and allows client to obtain account information, execute fund transfers and make payments. [17]

The rapid penetration of these technologies means that traditional bank branches, which are expensive to set up and operate, have decreased in importance and are no longer the sole or even the principal interface with clients. Popular estimates that in 2003 the proportion of clients using ATMs to transact business is the same as the proportion of clients that visits a Popular branch to conduct business (47%).

The securitization of financial assets in general, and of mortgage loans in specific, has also been a key factor in the development of the financial services sector in Puerto Rico during the last decade. For example, in Puerto Rico the origination of mortgages has traditionally been dominated by relatively smaller mortgage banking outfits. In the United States, commercial banks are the leaders in this segment of the market. The viability and profitability of the Puerto Rico mortgage banking industry is due in large measure to the existence of a highly liquid and stable market for mortgage-backed securities. These instruments allow the smaller mortgage banks to sell the credit and market risk associated with long-term mortgages to bondholders, while maintaining the relatively profitable "servicing" component of the underlying mortgages.

Alternative financial service providers in Puerto Rico, in contrast to the United States, have not witnessed a significant expansion in the last decade. While small loan companies remain the principal source of credit for the unbanked in Puerto Rico, by and large we have not witnessed an explosion of check cashing outlets, pawn shops and other similar operations. This phenomenon could be at least partly explained perhaps by a lack of demand for such services, given that the majority of the unbanked in Puerto Rico prefer to cash checks at mainstream financial institutions instead of using alternative providers. However, further study of this trend is needed before drawing more solid conclusions.

Finally, IDAs in Puerto Rico have made relatively little headway, perhaps due to existing structural limitations. Under a limited pilot program currently in effect in Puerto Rico, IDAs can be used only for acquiring a first home and for educational purposes. As of June 30, 2003, there were an estimated 300 IDAs outstanding in Puerto Rico. The slow growth of IDAs in Puerto Rico can be explained in large part by two factors. First, there is a lack of awareness on the part of policymakers about IDAs and how they can be integrated with existing welfare programs.

[16] Richard L. Carrión, *La Banca Electrónica Como Herramienta Para Promover la Bancarización*, presentation before the 20th Latin American Foreign Trade Congress of the Latin American Bank Federation, June 28, 2004, on file at the Center for the New Economy.
[17] Id.

Second, many welfare programs impose strict asset limits in order to qualify for benefits. These asset limits discourage welfare recipients from savings and in fact penalize them if they do.

Offering Financial Services to the Unbanked in Puerto Rico — The Killer Applications

Given the current state of the market for financial services, what products can be developed to entice the currently unbanked population to enter the financial mainstream? First, we know that a large majority of the unbanked population in Puerto Rico already uses financial institutions to cash checks on a monthly basis. In terms of the "credit path model" developed by Alternatives Federal Credit Union of Ithaca, New York, these individuals are already "transactors". The challenge is to move these consumers further along the credit path and encouraging them to become savers, then borrowers and finally, owners.[18]

We understand that a comprehensive approach, from both the supply and the demand side, is needed for individuals to successfully move along the credit path. However, the scope of this paper is limited to analyzing solutions from the supply side. Thus, in this section we set forth some suggestions for increasing the supply of financial services to the unbanked in Puerto Rico.

The challenge to reach the unbanked is to develop products with the following characteristics[19]:

- **Features that Help the Unbanked Overcome Barriers** – People can be motivated to join the financial mainstream either by providing supports, such as financial education or financial planning services, or by incentives, such as match deposits or tax credits.
- **Low Cost** – Development and operating costs need to be kept to a minimum so the product can be attractively priced.
- **Scalable** – Scale is the key to achieve cost-effectiveness. The product must be easy to sell in a big scale within weeks of rollout.
- **Compatible with Financial Institution Objectives** – Products must be compatible with other long-term objectives of the financial institution and they must make sense to the financial institution as a strategic business decision.

With these objectives in mind, we offer suggestions based on an analysis of innovative proposals and which constitute, in a sense, a synthesis of what could be called the "best practices" to reach the unbanked. In short, we present here products equivalent to what in the IT sector would be called "killer applications".

Beginner Accounts

These accounts would be low cost, simple to use, standardized and straightforward to maintain. The idea is to create an account that is essentially a commodity product, the financial services equivalent of a "widget," which can be efficiently mass marketed to the unbanked population. The "killer application", or ideal model for the beginner account, would have the following characteristics:

- Beginner accounts would be limited to electronic transactions;

[18] Seidman and Tescher, *From Unbanked to Homeowner*, *supra* note 11 at 11.
[19] Jeff Zinsmeyer, *Financial Products of the Future: The Next Generation of IDAs*, presentation before the IDA Learning Conference, (New Orleans, LA, September 21, 2004), on file at the Center for the New Economy.

- Accessible through an on-line, real time, debit card;
- Allow a minimum of 3 to 5 free cash withdrawals per month, without charge through proprietary ATMs;
- Provide access to POS network and allow cash withdrawals and cash back with purchases;
- Provide a monthly statement, either on-line or through the telephone;
- Require no minimum balance, unless it is required by law;
- Monthly fee capped at $3.00 (this is the federal limit for ETAs);
- Allow for additional deposits;
- Provide a basic bill payment feature for a fee (to be determined);
- Check deposits would be cleared immediately (no float);and
- At the customer's option, include a prearranged savings mechanism that automatically sweeps at least $10 per month to a savings account on the customers' name.

Stored Value Cards (SVCs)

Store value cards (SVCs) have been in circulation for some time. The original SVCs were transit fare cards and store-issued gift cards. These cards were not reloadable and the user had no available remedy if they were lost or stolen. The next generation of SVCs used magnetic stripe technology to store information and provide access to electronic networks through which funds can be tracked and stored, in a manner similar to traditional ATM cards.[20]

According to a recent paper published by the Center for Financial Services Innovation (CFSI), the SVC market in the United States has experienced strong growth the last few years in terms of both the number of providers and the number of users.[21] The increased popularity of SVCs coupled with technological advances which enhance their functionality, provides an "opportunity to marry the functionality of stored value cards with opportunities to save and build assets, transforming SVCs into powerful alternatives to traditional bank accounts."[22]

SVC networks can be operated either as "closed loop systems" or as "open loop systems". In a closed loop system, an issuer provides a card that can only be used for its products or at a limited number of merchant locations. For example, college-issued cards that can be used at cafeterias, bookstores and other campus locations operate in a closed loop system.[23] An SVC operating in an open loop system functions in a manner analogous to a traditional debit card and allow the consumer to execute various transactions at multiple points of sale, including making purchases at an assortment of stores or paying bills.

Stored value cards can also be issued in "branded" and "non-branded" formats. Branded SVCs have "a MasterCard or Visa logo and utilize signature-based technology to allow the consumer

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[20] Seidman and Tescher, *From Unbanked to Homeowner*, *supra* note 11 at 22.
[21] Katy Jacob, *Stored Value Cards: A Scan of Current Trends and Future Opportunities,* The Center for Financial Services Innovation Research Series White Paper #1, (Center for Financial Services Innovation: Chicago, July 2004), p.1.
[22] Id at 2.
[23] Office of the Comptroller of the Currency, *Payroll Cards: An Innovative Product for Reaching the Unbanked and the Underbanked*, (Washington, DC: Office of the Comptroller of the Currency, Community Affairs Department, October 2003), p.2.

to transact business anywhere that those brands are accepted, as well as through ATM and point of sale (POS) machines."[24] Non-branded cards, on the other hand, use PIN-based technology and can only be used to execute transactions through ATM or POS networks.

Finally, SVCs can be issued with different re-loading capability: some SVCs can only be re-loaded through direct deposit of a payroll check; others can be issued as reloadable payroll cards, which permit the holder to (1) access funds received via direct deposit and (2) reload the card in other ways; while still other SVCs can be reloaded in multiple ways at an array of locations, basically without limitation.

In our view, SVCs could be a particularly attractive delivery system of financial services to the unbanked in Puerto Rico because 55% of them already have experience accessing PAN funds (the local name for the food stamp program) using an electronic card. The "killer application", or ideal model for SVCs issued by Puerto Rico financial institutions, would have the following characteristics:

- Financial institutions would contract with a non-bank SVC vendor to operate the cards issued by local provider of financial services;
- Cards would operate in an open loop system;
- The cards would use PIN-based technology and allow access to funds in real time;
- The cards would be re-loadable at branches;
- Cards would provide ATM access, at least between 3 to 5 free withdrawals per month;
- Cards would also provide free access to POS network;
- Cards would have a bill payment option;
- In the U.S. some SVC providers offer consumers the ability to build a credit history by reporting to credit bureaus, a similar feature should be considered in Puerto Rico; and
- At the customer's option, a prearranged savings mechanism that automatically sweeps at least $10 per month to a savings account on the customers' name.

Individual Development Accounts (IDAs)

IDAs are bank accounts that have the following characteristics:

- They are savings accounts; in which
- Savings by the account holder are matched up to a certain amount by the financial institution offering the account or by a third-party community organization; and
- In order to receive the matching deposits, account holders usually agree to:
    - Participate in financial education classes;
    - Save a minimum amount each month; and
    - Use the money saved to acquire an asset such as education, downpayment on a first home or to capitalize a small business.

IDAs were developed in the late 1990s as an alternative to help poor people, specially the working poor, to start saving and building assets. Today, institutions in more than 40 states and Puerto Rico offer IDAs of some type.

[24] Id. at 3.

We suggest that financial institutions in Puerto Rico offer IDA accounts with the following characteristics:

- Account holders will be required to save a minimum of $10 a week.
- Financial institution will match up in a 2 to 1 ratio up to $1,040 per year.
- Withdrawals after three years will be permitted for (1) the downpayment on a first home, (2) education or vocational training, or (3) starting a small business.

Policy Recommendations: What Can the Government Do?

It is clear the low-income and unbanked sectors present a growth opportunity to financial institutions in Puerto Rico and there are indications that the market is moving, albeit slowly, to serve these segments of the market. The increasing diversity of financial service providers, in combination with technological changes in the industry, will ensure that thousands of Puerto Ricans eventually join the financial mainstream, where they have the opportunity to save and build wealth.

However, government can help jumpstart this process by implementing policies that provide incentives and encourage financial institutions to move faster and in the right direction. Set forth below is a set of recommendations for local policymakers to help increase financial access in Puerto Rico.

Implement Direct Deposit Rules

Electronic payment of wages and salaries would provide an incentive for thousands of Puerto Ricans to come into contact with the mainstream financial system. The government of Puerto Rico is the largest employer in the island, providing employment to approximately 30% of the active workforce. This pool of government workers can be used to establish a large direct deposit pilot program that can be used as an example and model for other large employers in Puerto Rico.

Direct deposit allows consumers to have deposits electronically credited to their savings or checking accounts. The implementation of a direct deposit program can serve as a prompt to open a banking account. The U.S. government has been extremely successful in the implementation of its direct deposit program, as 94% of federal government employees receive their pay via direct deposit, while 86% of the people receiving Social Security benefits use direct deposit. In Puerto Rico, however, the adoption of direct deposit has not been as widespread. According to our analysis, the use of direct deposit services by government employees, which constitute 30% of the labor force, is very low as approximately only 29% of government employees use direct deposit.

Change the Mode of Payment of the Nutrition Assistance Program and TANF Program Benefits

Puerto Rico, like most other states, pays welfare benefits in the TANF program and the Nutrition Assistance Program electronically through an electronic benefits transfer (EBT) system. Unfortunately, the way the EBT system has been set up in Puerto Rico, and in most states, has minimized the extent to which electronic transfer could be utilized as an entry point to banking. Puerto Rico does not establish bank accounts for benefit recipients. Instead, Puerto Rico uses a private contractor to provide beneficiaries with debit card-based access to the amount of benefits they have been allocated while the actual funds are held by the Commonwealth government in a pooled account. Switching from an the EBT system to an electronic funds transfer (EFT) system whereby each recipient has its account could reduce administrative costs for the Commonwealth government and facilitate the introduction of a significant number of unbanked recipients to the financial mainstream.

Provide Subsidy to Financial Institutions that Offer Beginner Bank Accounts

In order to induce financial institutions to offer the starter accounts described above, the Commonwealth's government could offer a one-time subsidy, either in cash or through a one-time tax-credit, to compensate them for the start-up costs related to structuring and setting-up these accounts. The U.S. Treasury offered a one-time reimbursement of $12.60 per account for each ETA opened by a financial institution. The amount of the subsidy for Puerto Rico would have to be determined after conducting a study of the cost structure of local banks.

Enact Legislation Granting Favorable Tax Treatment to all IDAs in Puerto Rico

Individual Development Accounts are a powerful incentive to join the financial mainstream and start building up assets. However, in the absence of specific tax-legislation exempting income, interest and matching deposits from taxation, these accounts may lose their attractiveness to many potential savers because they would taxed on income they could not access for, in many cases, years. Many states have enacted this type of legislation to exempt qualified IDAs from state tax.

Grant a Tax Credit to Financial Institutions that Match IDA Deposits

In order to facilitate the expansion of IDAs to a significant scale, the government of the Commonwealth should consider providing a tax credit to reimburse financial institutions for matching funds they provide to qualified persons savings in an IDA, up to a specified dollar amount (for example, $1,000) per person per year.

Revise Asset Limits in Social Welfare Programs

Under current law, eligibility for many social welfare programs is linked to asset holdings. In many cases, program regulations set forth extremely low asset limits in order to qualify for program benefits. The application of low asset limits constitutes an enormous disincentive for saving. The Government of Puerto Rico has the authority to set and modify asset limits for the TANF and Nutritional Assistance programs and government-financed health insurance. Specifically, program regulations should be amended to state that restricted assets, such as IDAs, should be disregarded in determining compliance with asset limits.

Fund Research Efforts to Yield Better Information About the Unbanked

In order to gain further insights on the composition of the unbanked population in Puerto Rico and on the potential products to attract them to the financial mainstream, the government could fund research efforts focused on gathering household-level data captured by detailed surveys and focus groups. In the United States, one of the most reliable sources of information on consumer finances cited by the academic and policy literature on asset building is the Federal Reserve's Survey of Consumer Finances (SCF). Unfortunately, the SCF does not include data for Puerto Rico households nor does the Panel Study on Income Dynamics (PSID), another important source of household-level financial data. In the absence of these data sources, Puerto Rico should develop its own data source modeled, in part, on the SCF. Ideally, it would follow a similar sampling methodology that includes a Puerto Rico-wide probability sample and an oversampling of unbanked households. In addition, in order to get at more specific issues regarding products for unbanked and underbanked households, the government should also provide funds to carry out focus groups. Both instruments will provide a valuable data set from which further research would be performed to test numerous hypotheses regarding unbanked/underbanked households and financial behavior.

Enable Taxpayers to Open Bank Accounts Directly on Their Income Tax Forms

The Puerto Rico Department of the Treasury should allow taxpayers to open a checking, savings or IRA account directly on their tax forms. This would allow taxpayers receiving refunds to get their refund deposited directly into their account, thereby reducing administrative costs associated with processing refunds and increasing the number of persons with access to a bank account. The Treasury Department would have to solicit proposals from private financial institutions to provide these low-cost quality accounts.

Conclusion

At the dawn of the 21st century it is difficult to explain why 36% of the population of Puerto Rico, which has one of the most competitive financial service sectors in the world, does not have access to a bank account. Improving financial access is a significant step in eliminating other forms of social exclusion. In the words of Ruth Kelly, Financial Secretary to Her Majesty's Treasury, "a job is not enough, freedom from crime is not enough, if you are marginalized from the financial system and ghettoized in a cash economy."[25] Financial access is also crucial to realize the potential of asset-building policies.

With strong leadership and cooperation, financial institutions can make a significant contribution to helping Puerto Ricans make the most of life's chances. Financial institutions, in other words, can be of assistance in creating social structures which expand the set of opportunities and possibilities available for individual action in Puerto Rico.

[25] Mick Brown, Pat Conaty, and Ed Mayo, *Life Saving: Community Credit Unions*, New Economics Foundation White Paper, (Cinnamon House, London: New Economics Foundation, July, 2003), p.3.