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Building a Nation of Owners: Utilizing Credit Unions to Increase Financial Access and Expand Asset Ownership in Puerto Rico

Building a Nation of Owners: Utilizing Credit Unions to Increase Financial Access and Expand Asset Ownership in Puerto Rico

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Ad Majorem Dei Gloriam

The Center for the New Economy

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TO SOFÍA ISABEL MARXUACH:
So that some day, when she grows up, she may understand that her daddy tried to do the best he could with the time he has been given.

I. 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 2002 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, as we will explain below, 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, for example, 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

[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] Gaither International Puerto Rico, Inc., "A Survey Among Unbanked Households in Puerto Rico", September 2002, on file at the Center for the New Economy.

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 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.

Asset building enables poor households to save in small amounts and to accumulate modest stocks of wealth. The principal reason to save, of course, is having enough funds on hand – precautionary savings – to buffer the inevitable fluctuations in income and to deal with health and other emergencies.[6]

In addition, asset building policies in most developed countries seek to stimulate poor people's savings beyond "rainy day savings" and provide incentives for investment to enhance their unstable incomes and improve their ability to leave poverty behind. These programs usually focus on encouraging saving for things such as the down payment on a house, buying a decent car for transportation to work, expanding education, or establishing a small business. That is, these programs focus on the development of capabilities – housing, education, building a credit history – which enable poor households to escape from poverty.

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

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[4] Amartya Sen, *Development as Freedom*, (New York: Anchor Books, 1999) p. 75.

[5] Michael Sherraden, *Assets and the Poor: A New American Welfare Policy*, (New York: M.E. Sharpe, Inc., 1991) p.7.

[6] 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.9.

must operate – welfare bureaucracies, financial services providers and nonprofit organizations – traditionally are not connected to this informal world.[7]

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.[8]

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.[9]

This paper seeks to address the breakdown of the financial services market in Puerto Rico from the perspective of one key segment of the supply side. In specific, we will examine the present and potential future role that local credit unions may play in supplying financial services to the unbanked population in Puerto Rico, through the development of new products, new alliances and the strengthening of the cooperative sector in Puerto Rico.

In our view, the willingness of credit unions to work and be flexible with their clients, in addition to their positive image in the community, their social mission anchored in cooperative principles, their importance as cultural/social centers, their experience, albeit on a case by case basis, in offering services to the unbanked, their relative financial strength, their geographic presence and the new legal powers granted credit unions in Puerto Rico by recent legislation, endow credit unions with the potential to bridge this gap between the informal financial practices of the unbanked population in Puerto Rico and the formal institutions of finance.

[7] 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.
[8] Cornell, *Asset Building and the Escape from Poverty*, *supra* note 6 at 11.
[9] Id.

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. In addition to policy initiatives, we also believe that, given their characteristics, credit unions can and should play a major role in addressing this situation.

We elaborate these arguments through out this paper as follows: In the second part, we present a brief profile of the unbanked population in Puerto Rico. In part three, we summarize the current state of the debate in welfare policy circles and set forth the case in favor of establishing anti-poverty policies which encourage asset building in Puerto Rico. In part four, we offer a synopsis of the history of the cooperative movement in Puerto Rico, describe the current state of credit unions in Puerto Rico and analyze their powers, markets, operations and products. In part five we explore the kind of financial services and products that are currently offered and those that can be offered by credit unions, both by utilizing their own powers to maximum and by building alliances with other participants, to reach the unbanked population in Puerto Rico and help these households start accumulating assets. Finally, in part six we present our principal findings, offer some policy recommendations for government, outline some recommendations for credit unions and identify areas for further research.

II. Profile of the Unbanked in Puerto Rico

A. Characteristics of the Unbanked in Puerto Rico

According to a study conducted in 2002 by Gaither International, approximately 454,000 households in Puerto Rico, 36% of all Puerto Rican households, did not have a bank transaction account.[10] 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 Gaither 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 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

[10] 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. All data regarding the unbanked in this section is from the Gaither International 2002 study, *supra* note 3.

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. See Table 1 below for a breakdown of the sources of monthly non-work family income in unbanked households in Puerto Rico.

Table 1
Sources of Monthly Non-Work Family Income In Unbanked Households

Source	Household Incidence	Avg. Among Those Receiving Income from This Source
PAN	55%	$241
Soc. Sec.	38%	$462
PAE	7%	$92
Govt. Pension	4%	$588
Other Govt.	5%	$239
ASUME	7%	$221
Relatives	6%	$113
Prof. Fees	3%	$917
Pension Private Co.	1%	$627
Rental Income	1%	$255
Other	3%	$362

Source: Gaither International

In 2002, among those households that reported income from government sources, 65% reported receiving government checks and 57% reported receiving government payments via electronic transfer.

Of those unbanked households that received checks from government sources, 52% cashed them at financial institutions, mostly at banks (39%), followed by credit unions (9%) and *financieras* (4%); 33% cashed them at stores, mostly convenience stores (26%); and 15% cashed them at other sites, including check cashing outlets (4%). The overwhelming majority (86%) of these establishments did not charge a fee for cashing government checks. Among the 14% that did charge a fee, the average fee was $4.20. Check cashing outlets were also the most likely to charge a fee for cashing government checks.

Among the unbanked, 73% did not have credit, at least not through formal providers. Of the 27% who had a credit relationship, 81% reported having at least one loan outstanding. The principal source of credit was the small consumer loan company (*financieras*) (60%), followed by banks (32%) and credit unions (13%).[11]

In terms of savings incidence, 8% of unbanked households reported savings of some sort in 2002. Of the 8% of households that reported savings, 85% said the principal reason for saving money was for emergencies. A substantial majority of these unbanked savers, 89 percent, reported they keep their savings inside the home.

The most common method used by the unbanked to make payments is to make payments in person at an office of the agency/company they need to pay and to make such payments in cash. Approximately 70% of the unbanked paid their electricity and water bills in person at a local office of the utility company, while 65% of the unbanked made their payments for housing in the same way. Ninety-nine percent of unbanked households paid for their utilities (electricity, water, and telephone) in cash, while 84% of unbanked households used cash to pay for other recurrent expenses, such as rent/housing, groceries and cable TV.

The most common reason cited for not having a checking or savings account (79%) was the perception of not having "enough money left over" at the end of the month. This response was most prevalent among persons 35 years or older, females, unemployed consumers, with less education and lower income than the rest of the unbanked.

The other reasons cited for not having a bank account were:

- Banks charge for everything (4%);
- Not interested in banks (3%);
- Did not trust banks (2%);
- Fear of losing eligibility for the government health insurance program (2%);
- Difficult to go to bank (2%); and
- Do not want any relationship with banks (2%).

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

[11] Some respondents had loans outstanding with different credit providers.

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, this 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.

B. Costs of Being Unbanked

There are significant costs both, economic and social, associated with the lack of account ownership. Michael Barr has identified 5 basic types of costs associated with being unbanked[12]:

- Financial cost of using basic financial services;
- Constraints in the ability to save;
- Reduced access to credit;
- Higher risk of robbery; and
- Inefficiencies in the payments system impose costs on the economy at large.

In addition, we have identified two additional sets of costs associated with being unbanked in Puerto Rico. First, is the opportunity cost of all the wasted man-hours every year in connection with the payment of bills in person at a local office. Second, and perhaps most significant of all in the case of Puerto Rico, 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.

In terms of the financial cost for accessing basic financial services, we have seen that those costs in Puerto Rico, while lower than in the United States, are still greater than zero. These check cashing fees are paid by families that had an average monthly income of $706, mostly for cashing checks issued by the government (the most important source of income for the unbanked in Puerto Rico), which represent relatively low risk for check cashing establishments.

A significant portion of these check cashing costs could be avoided, if recipients had bank accounts, by directly depositing government funds via electronic funds transfer (EFT) into their accounts. The government would also save money by using an electronic funds transfer system instead of checks. The U.S. Treasury estimates that it

[12] Barr, "Banking the Poor", *supra* note 2 at 134-141.

costs 2 cents to make an EFT payment, compared to 43 cents for a check payment.[13] Furthermore, the federal government could save an estimated $100,000,000 in postage and check production costs by switching to an all-electronic payment system.

According to an analysis by Banco Popular, the government of Puerto Rico would save over $8,000,000 per year in check processing costs alone if all government employees and retirees used direct deposit. This estimate does not include savings related to reductions in fraudulent transactions and in duplicated transactions due to lost or damaged checks. The government of Puerto Rico should study the potential cost savings associated with converting all its payments, not only payroll and retiree pensions, to electronic form.

Second, lack of access to a bank account makes it extremely difficult and inefficient for the unbanked to save. The unbanked need to save for the same reasons that we all do: to ride out emergencies, to acquire a home, to finance the education of children, and for retirement. In addition, savings are associated with greater household stability, higher educational attainment and local civic involvement.

However, the unbanked face several obstacles to increase savings. As we have seen, most of the unbanked in Puerto Rico are low income. In general, low-income households face higher opportunity costs for using their limited financial resources for savings rather than allocating them for current consumption. In addition, the unbanked often lack access to any regular mechanism to save, which impedes the accumulation of savings, even if in a family that has the desire, the income and the will to defer consumption. On the other hand, financial institutions have little incentive to target the unbanked because they face "high costs in collecting their savings relative to the amounts saved and will thus be reluctant to expend resources to open accounts for them or will offer them relatively low returns on their savings, further reducing any incentives the poor have to save."[14] Thus, we can expect the unbanked to save little or nothing at all.

This expected theoretical result is borne out in Puerto Rico, where only 8% of the unbanked population reported savings of some sort in 2002. While the data does not allow us to attribute this low incidence of saving solely, or even primarily, to the lack of access to a bank account, it is reasonable to assert that such lack of access is at least one of the principal contributing factors for such a low savings rate among the unbanked. Recent research in the United States indicates that access to financial services can indeed play a major role in the accumulation of savings and that low-income families with bank accounts are more likely to own other assets, such as savings or retirement accounts.[15] In short, providing reasonable access to the financial system seems to be a necessary, but not sufficient, condition to increase the savings rate among low-income households in Puerto Rico.

[13] Michael A. Stegman, *Savings for the Poor: The Hidden Benefits of Electronic Banking*, (Washington, DC: Brookings Institution Press, 1999) p.5.
[14] Barr, "Banking the Poor", *supra* note 2 at 136.
[15] 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. 2.

Another cost associated with being unbanked takes the form of reduced access to credit. Without a bank account it is extremely difficult to qualify for a loan or to establish a credit history. Sherraden believes this is essentially an information problem because providers of financial services are good at evaluating financial information but not very good at evaluating other kinds of information. When an unbanked person applies for a loan, the borrower may have more accurate information about the risk of the loan than does the lender. The lender, therefore, charges a premium to cover the perceived higher risk, even in the case of borrowers that may be highly creditworthy but for the absence of a bank account. Thus, says Sherraden, "when credit is available at all, it is often paid at a premium because of this imperfect information and imperfect valuation." [16]

This inability to discriminate (in the good sense) between good and bad risks among the unbanked, imposes unfairly high borrowing costs on all unbanked borrowers. This is particularly pernicious when it affects persons who are responsible in the management of their affairs but lack access to a bank account. For example, a person that pays in cash her rent, water, telephone and electricity bills consistently on time every month has demonstrated discipline and responsibility in the management of her financial affairs. Yet, because she is unbanked and pays all her bills with cash, this person may face a very difficult time in obtaining a loan, and if she does, it will probably be at a substantial above-market premium, because she can not demonstrate her creditworthiness to the lender with information that the lender can readily evaluate in making the risk assessment in connection with her loan.

This pattern appears to be prevalent in Puerto Rico, where 73% of the unbanked did not have credit, at least not through formal providers. Of the 27% that had a credit relationship, 81% reported having at least one loan outstanding. The principal source of credit was the *financieras* (60%), followed by banks (32%) and credit unions (13%). Small loan companies charge higher interest rates than the banks or credit unions. For example, the weighted average interest rate charged by small loan companies for loans originated during the second quarter of 2004 was 27.46%, while the weighted average interest rate charged by credit unions on unsecured personal loans originated during the same period was 18.85%.[17] Thus, when credit was available to the unbanked, it was often paid at a substantial premium.

Fourth, the unbanked who cash their government benefit or payroll checks may also face a higher risk of robbery and theft because they are more likely to handle large discrete bundles of cash during the same period of every month. In addition, of the 8% of unbanked households that reported savings, a substantial majority, 89 percent, reported they keep their savings inside the home, thus increasing their risk of exposure to crime.

If these persons had bank accounts, they could execute their transactions over the entire month, instead of going to the bank every month (usually on the same days each month); withdraw cash in smaller amounts as they needed it; and store savings safely in

[16] Sherraden, *Assets and the Poor*, *supra* note 5 at150.

[17] Information on average rates was provided by the Office of the Commissioner of Financial Institutions of the Commonwealth of Puerto Rico, on file at the Center for the New Economy.

a federally-insured depository instead of hiding them in the home, thus, reducing their risk of exposure to crime.

Fifth, according to Barr, "inefficiencies in the payment system impose costs on the national economy" and "increasing the efficiency of payment systems for the poor could have modest positive effects on the economy as a whole."[18] A study by the Federal Reserve Board estimates check processing costs (not including fraud) to be between 0.25% and 1.00% of U.S. GDP and that savings of up to $30 billion could be generated if one-half of current check volume in the United States is converted to electronic payment.[19]

The Puerto Rico banking system follows very closely the U.S. banking system, is subject to the same rules and regulations and is regulated by the same federal entities. Therefore, if we use the Federal Reserve cost estimates, check processing costs for Puerto Rico during fiscal year 2002 can be estimated to be between $177,000,000 and $711,000,000, not including costs associated with fraudulent transactions. These costs could be reduced significantly if the government of Puerto Rico instituted electronic payment for all its obligations, including benefit transfers.

Furthermore, due to network effects, the money spent in the conversion to electronic payments by the government may spur the conversion to electronic payments in the Puerto Rican economy as a whole. An electronic payment system is valuable only if: (1) a significant number of banks issue cards for use over the network; (2) consumers decide to use it across the board and (3) retailers far and wide decide to accept it. The government, which is the largest employer in Puerto Rico, by taking the first step in making electronic payments, may eliminate some of the risks inherent in the switch to electronic payments and make participation in the network attractive to all key actors, that is, banks, consumers and retailers.

Sixth, as we have seen in the previous section, most of the unbanked in Puerto Rico pay their utilities and many other recurrent monthly expenses in person at the office of the company/agency they need to pay. Approximately 70% of the unbanked paid their electricity and water bills in person at a local office of the utility company, while 65% of the unbanked made their payments for housing in the same way. Ninety-nine percent of unbanked households paid for their utilities (electricity, water, and telephone) in cash, while 84% of unbanked households used cash to pay for other recurrent expenses, such as rent/housing, groceries and cable TV.

This pattern of payment implies that thousands of man-hours every year are spent by the unbanked in Puerto Rico commuting from home to the commercial office/customer service office of these companies, standing in line, and commuting back after making the payment. This pattern may be repeated over and over every month for five or six different service providers. Although further research is needed on this issue, it appears to us that the opportunity costs associated with this behavior are high. If the customer is unemployed, she is wasting valuable time that could be put use in a training/education program or actually looking for work. If the person is employed part-time, she is

[18] Barr, "Banking the Poor", *supra* note 2 at 141.
[19] Id.

misusing time that again could be used for training/education purposes. And if the person is employed full-time, this entails being absent from work for significant periods of time every month. To our knowledge, a full accounting/estimate of this loss in productivity has not been conducted in Puerto Rico. However, logic dictates that if the number of unbanked persons is substantially reduced, we can expect the number of persons who make payments in person, and the lost productivity associated with this way of making payments, to be also substantially reduced.

Finally, as we have been stressing since the beginning of this paper, 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. We will explain these benefits in depth in the next section of this paper. However, here we just want to make clear that, in our view, a full accounting of the costs of being unbanked must include the foregone welfare effects associated with asset accumulation.

Michael Sherraden first identified these "welfare effects of assets" in his 1991 book, *Assets and the Poor*. According to Sherraden, asset accumulation could be expected to be associated with:

- Improving household stability;
- Creating an orientation toward the future;
- Stimulating the development of other assets;
- Enabling focus and specialization;
- Providing a foundation for risk taking;
- Increasing personal efficacy;
- Increasing social influence;
- Increasing political participation; and
- Enhancing the welfare of offspring[20]

Recent research in the United States tends to demonstrate that assets indeed 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, superior educational achievement, local civic involvement and increased levels of health and well-being among adults. Assets also tend to be associated with decreases in both marital dissolution and intergenerational poverty transmission.[21]

As we will explain in the next section, asset accumulation does not tend to occur spontaneously, government policies are usually required to encourage asset accumulation. However, even the best designed government policies are not bound to

[20] Sherraden, *Assets and the Poor*, *supra* note 5 at 148.

[21] Ray Boshara, *American Stakeholder Accounts*, New America Foundation Asset Building Program Issue Brief #2, (Washington, DC: New America Foundation, June 2003) p. 1.

be very effective in achieving this goal if a substantial portion of the population lives at the margins of the mainstream financial system and faces serious constraints in its ability to save and establish credit.

Thus, we need to include here, along with the other the costs of being unbanked, the foregone welfare effects that asset-holding could generate for 454,000 families in Puerto Rico and the reduced effectiveness of government in the implementation of asset-based policies to reduce poverty in Puerto Rico. We also need to include here the costs associated with the manifold existing income-based welfare programs and the billions of taxpayer dollars spent every year addressing social problems such as alcoholism, violent crime, child abuse, drug addiction, teenage pregnancies and domestic violence, which, to a large extent, are directly related to poverty.

In summary, a relatively large portion of Puerto Rican households are unbanked and there are significant costs, economic and social, associated with this lack of account ownership. Among these costs are the foregone welfare effects that asset-holding generates. We now proceed to explore in full the importance of asset ownership, the extent of the welfare effects associated with ownership of assets, and why asset-based policies are important, indeed required, for the long-term elimination of poverty in Puerto Rico.

III. The Importance of Assets

A. What is Asset-Building?

The concept of asset building has been defined in various ways. For purposes of this paper we will use the definition adopted by the New America Foundation, one of the leaders in the field of asset building policy and research, which has defined asset building as "public policy and private sector efforts to enable persons with limited financial resources to accumulate and preserve long-term, productive assets—savings, investments, a home, post-secondary education and training, a small business and a nest-egg for retirement."[22]

These public and private efforts to promote asset building are designed to be a complement to, rather than a substitute of, current income-based welfare polices which are intended to support a minimum level of subsistence. These new policies are based on concepts of savings, investment and asset accumulation rather than on the concepts of income, spending, and consumption that direct current policy. According to Sherraden:

> The major reason for this proposed policy shift is that income only maintains consumption, but assets change the way people think and interact with the world. With assets people begin to think in the long-term and pursue long-term goals. In other words, while incomes feed people's stomachs, assets change their head.[23]

As we will explain shortly, asset building policies for the nonpoor have a long history in the United States. These policies have spurred the creation of a variety of institutional structures which facilitate wealth accumulation by the nonpoor. Sherraden's point is that the poor have few such structures within which to accumulate assets and that government policy should focus on creating those structures instead of merely transferring a monthly allowance to finance consumption. His proposal is to stimulate wealth accumulation by the poor as a means for them escape poverty, bearing in mind that "wealth is not income, spending and consumption, but rather savings, investment and accumulation of assets."[24]

1. A Short History of Asset-Based Policies in the United States

Initiatives to encourage asset accumulation by individuals have been suggested since the founding of the United States. For example, Thomas Paine, in his 1797 pamphlet *Agrarian Justice*, proposed the creation of a national fund from which each citizen would be given an asset pool. Every citizen, Paine argued, had a right to a stake of fifteen pounds sterling at the age of 21 and also to the sum of ten pounds sterling per year during life after reaching fifty years of age. Paine's system of stakeholding would apply to

[22] This definition is from the asset building website sponsored by the New America Foundation at http://www.assetbuilding.org/AssetBuilding.
[23] Sherraden, *Assets and the Poor*, *supra* note 5 at p.6.
[24] Id.

both men and women and would be financed through a 10% tax on inheritances, so the wealth of one generation could endow the next.

Other historic initiatives to expand asset-holding include the Homestead Act of 1862, the creation of the Federal Housing Administration (FHA) in 1934 and the GI Bill of 1944. The Homestead Act was the first asset-based welfare policy in the United States. This Act facilitated the transfer of land to pioneers who went west, claimed their stake and worked the land. Under the Homestead Act and subsequent land acts over 200 million acres of public lands were transferred to farmers, ranchers and timbermen.[25]

The Federal Housing Administration was created to broaden homeownership in the United States. Through its mortgage insurance and other financial products, it has played a major role in expanding the homeownership rate in the United States, which was 68% in 2002.[26]

The GI Bill offered veterans returning from the battlefields of World War II grants for training and higher education, loans for financing new businesses, and mortgages to purchase homes. Between 1944 and 1956 the federal government spent $14.5 billion to benefit almost 8 million veterans.[27] By any measure, the GI Bill of 1944 was one of the most successful asset-building policies in the United States.

More recently, federal asset building initiatives have focused on providing tax incentives for home ownership and retirement. For fiscal year 2005, the tax expenditure value of the deductibility of mortgage interest on owner occupied housing was $69.740 billion, while the exclusion of capital gains on home sales cost the U.S. treasury $21.490 billion in forgone revenue. On the other hand, tax expenditures for retirement (net exclusions of pension contributions associated with employer plans, 401(k) plans, IRAs and Keogh plans) were estimated at $150 billion for FY 2005.[28] Over 90% of these benefits accrued to households with incomes in excess of $50,000.

B. Why Assets?

Thus, the federal government has implemented a series of policies which directly or indirectly subsidize or otherwise encourage the nonpoor to acquire and accumulate assets throughout their lifetimes. The importance of these asset building initiatives is that they have created structures through which savings "enter households as assets from the beginning".[29] These policies, however, often do not reach the poor. In general, social welfare policies for the poor do not stimulate savings and often discourage it. The question raised by Sherraden is why not do the same for the poor?

1. The Intellectual Debate: Asset Building to Reduce Poverty

It is not easy to appreciate the innovative nature of asset building policies for the poor without a sense of the state of the intellectual debate about welfare policy and poverty

[25] Sherraden, *Assets and the Poor*, *supra* note 5 at 191.
[26] Reid Cramer, *Net Worth at Birth: Creating a National System for Savings and Asset Building with American Stakeholder Accounts*, New America Foundation Asset Building Program Working Paper, (Washington, DC: New America Foundation, March 16, 2004) p.7.
[27] Id.
[28] Id.
[29] Sherraden, *Assets and the Poor*, *supra* note 5 at 177.

theory and why asset building is different. Sherraden devotes a substantial part of his book to this analysis and we offer a brief summation here.

Sherraden begins his discussion by pointing out that while professors, politicians, and sociologists spend significant time and effort conversing about welfare, "we do not know very well what welfare *is* or how families achieve it."[30] There are, however, plenty of theories of poverty and social class. These theories can be broadly classified in two groups, individual behavior theories and structural theories.

> In brief, individual-level theories suggest that undesirable or unproductive behaviors cause poverty. On the other hand, structural theories suggest that circumstances of poverty cause behaviors; that is apparently dysfunctional behaviors are adaptations to poverty. At the extreme, both types of theories are highly normative. Intertwined through the writings of individual behavior theorists is the moral judgment that people who are doing poorly are deficient in ability, training or morality and should pick themselves up and do better. And intertwined through the writings of structural theorists is the moral judgment that the current social structure is poor and should be changed.[31]

Underlying all these theories, however, is the unchallenged assumption that income and consumption are the appropriate benchmarks by which to measure household welfare. Sherraden instead proposes a broader, more dynamic, integrative theory of welfare that circumvents the individual versus social structure duality and takes into account the effects of asset accumulation. This theory has two main features:

> First, it would view household financial welfare as a long-term dynamic process rather than a cross-sectional financial position at a given time. Assets capture this long-term dynamic quality better than income because assets reflect lifetime accumulation. Second, the theory would propose that more than consumption is involved in household financial welfare, possibly much more. In other words, according to this viewpoint, assets yield positive welfare effects that income alone does not provide, effects in addition to deferred consumption.[32]

Sherraden's suggestion is that assets have a variety of important economic, psychological and social effects. "Simply put, people think and behave differently when they are accumulating assets, and the world responds to them differently as well."[33] We explore these effects in the following section.

2. Positive Welfare Effects

According to Sherraden, asset accumulation could be expected to be associated with:

- **Improving household stability** – Assets cushion income shocks associated with events such as illness, divorce or sudden unemployment, which may throw people into income poverty. In addition, assets reduce liquidity constraints by opening access to credit. When assets are present there is less turmoil in the household until sufficient income can be reestablished, because assets stabilize income.

[30] Sherraden, *Assets and the Poor*, *supra* note 5 at 35.
[31] Id at 36-37.
[32] Id at 44.
[33] Id at 148.

- **Creating an orientation toward the future** – Assets by nature are future-oriented, in the financial realm they connect the present with the future. Ownership of assets fosters long-term thinking. In simple terms, when assets are present, people begin to think in terms of assets. For example, "if a young mother owns her home, she begins to pay more attention to real estate values, property taxes, the cost of maintenance and so forth. If she has a certificate of deposit, she is more likely to pay more attention to interest rates and what makes interests go up and down. If she owns 25 shares of IBM stock, she is more likely to pay attention to news about IBM, the computer business in general, the stock market and alternative investment options."[34]

- **Stimulating the development of other assets** – Assets influence the behavior of the people who own them. If they own physical assets they will take care of them and try to improve them. If they own financial assets, they are more likely to educate themselves about investments and learn about the market and investment management, that is, they increase their intellectual capital. In addition, assets have returns that can beget other assets (education and training) or provide a larger income stream in the future.

- **Enabling focus and specialization** – People in poor households spend their time doing a diversity of tasks because they do not have enough assets to enable them to focus and specialize. According to Sherraden, poor people "forego opportunities for specialized education and training because they have to feed their families. In economic terms, specialization yields a division of labor and comparative advantage, but asset-poor households do not have much opportunity to develop a comparative advantage."[35]

- **Providing a foundation for risk taking** – In general, a household with more assets can diversify its holdings and protect itself against the consequences of taking a loss. In other words, with more assets, the ability to take financial, psychological and social risks is enhanced.

- **Increasing personal efficacy** – Assets can be a source of empowerment. They allow and provide a measure of security, strength and control at least over some aspects of our daily lives. In short, assets can enable people to emerge from the mindset of dependency and serve as a counterbalance to learned helplessness and feelings of powerlessness.

- **Increasing social influence** – According to Sherraden, who draws on sociology and other research, assets yield social status effects in addition to economic well-being. In addition, assets can provide social capital returns in the form of access to powerful networks, contacts, and information. In Sherraden's terms, "in a wealthy family, 'phone calls are made' to open doors, bend rules and move to the head of the line."[36]

[34] Id. at 155.
[35] Id. at 159.
[36] Id. at 164.

- **Increasing political participation** – With a stake in the system, it pays to keep track of what politicians are doing. In general, people can no longer afford to live in segregation and it makes sense to "join the system." In countries with larger informal sectors, "joining the system" "means participating in the formal economy, starting to pay taxes and otherwise playing the full role of citizenship."[37]
- **Enhancing the welfare of offspring** – Households with enough assets to avoid worrying about daily survival are better at endowing children with human assets, including nutrition, good health care, better educational opportunities and sophisticated acculturation. These human capital assets enhance the welfare of offspring throughout their lifetime. In addition, Sherraden emphasizes the "intergenerational connection" via the transmission of physical assets, "that income and consumption cannot provide."[38]

These nine "welfare effects" are what economists label "positive externalities" associated with asset accumulation. The core idea is that assets contribute positively to household welfare in both economic and non-financial terms, by essentially increasing the stock of human capital available to the household. This increased stock of human capital allows individuals to have a better chance of taking advantage of life's opportunities and of overcoming structural limitations imposed by the society at large. Therein, in those improved life chances, is where we find the genuine benefit of asset accumulation.

3. Justice/Fairness Arguments in Favor of Asset Building

In addition to the welfare effects set forth above, arguments in favor of asset building policies can be based on justice and fairness grounds. From a philosophical perspective, as Yale Law School professors Bruce Ackerman and Anne Alstott noted in their 1999 book *The Stakeholder Society*, asset building recognizes that "no person is inherently better than any other, and thus everyone has a right to a fair share of initial resources with which to begin and plan her adult life, regardless of whether her parents were rich or poor, frugal or improvident."[39] After all, we would be appalled if rich people had more votes than the poor, or vice versa, based solely on socioeconomic status. In the same way that one-person one-vote is indicative of political equality, providing every citizen an equal chance to accumulate assets expresses equality of opportunity.

Second, asset building respects individual liberty by allowing persons to use their assets as they see fit. No citizen is obligated to save or accumulate assets or, if she does, to justify her plan to use them to a government bureaucrat. Asset holders then are not only equal but free to pursue their interests in the way that makes sense the most to them. Their failures and their achievements are their own.

[37] Cornell, *Asset Building and the Escape from Poverty*, *supra* note 6 at 13.
[38] Sherraden, *Assets and the Poor*, *supra* note 5 at 166.
[39] Bruce Ackerman and Anne Alstott, *The Stakeholder Society*, (New Haven, CT: Yale University Press, 1999) p. 32.

Asset building is also a matter of fairness. As we stated above, both the federal and Puerto Rico tax codes provide substantial tax incentives for homeownership, college education, business ownership, investments and retirement that disproportionately benefit the upper socioeconomic classes. By establishing policies that encourage asset building by the poor and lower middle classes, they will be able to partake for the first time in the kind of social and economic returns generated by these policies. Asset building would level up the playing field across social classes.

4. Other Arguments in Favor of Asset Building

Asset building would represent a new approach to welfare policy in Puerto Rico. In general, welfare policy in Puerto Rico traditionally has focused on the issue of income distribution. If we employ the often used metaphor of a ladder, traditional welfare policy addresses the question of how far apart are the rungs in the ladder. The usual answer is to reduce the distance between the rungs by providing income supports for the poorest, while mostly ignoring the working poor. The failure of these policies has been stark. Today 44% of Puerto Rican families and 58% of their children live in poverty.

Asset building, on the other hand, addresses issues of opportunity, that is, it focuses on the question of who occupies which rung of the ladder and the related issues of social mobility within and between generations. Unlike traditional approaches to social welfare, it seeks to provide all citizens not with a temporary palliative but with the means to genuinely take advantage of their talents and move up the ladder for good.

Spreading asset ownership will also serve as a powerful new engine of economic growth and employment, as generations of young Puerto Ricans invest in their education and start new business ventures. Of course, many will fail and still others will make foolish decisions with their assets. But many others will not. Over the long-term, this increase in entrepreneurial activity will pay off, with a net positive effect on economic and social life. In addition, as the private sector grows, there will be less pressure on government to provide employment to hundreds of thousands of Puerto Ricans.

Finally, asset building could be a powerful tool in changing the nature of the increasingly inflexible class structure that is emerging in Puerto Rico: a lower class destined to dead-end jobs and rampant unemployment, an upper class of professionals enjoying unprecedented prosperity, and an enormous middle class trapped in the swampy quagmire of economic stagnation. Social policy thinking in Puerto Rico has not caught up with this emerging reality. On one hand, we offer generous subsidies and tax breaks to foreign capital and to those in the upper class (preferential capital gains, 10% on dividends etc.). On the other, we offer some meager help to the underclass. To the vast working middle class in between we offer nothing. Asset building can change this social dynamic by breaking the cycle in which inequality of outcomes in one generation becomes inequality of opportunity in the next.

So far we have presented a profile of the unbanked population in Puerto Rico and the costs associated with lack of access to financial services. We have also seen that lack of financial access is a strong impediment to accumulating assets and we have set forth the benefits associated with asset accumulation. We now proceed to explore the credit union sector in Puerto Rico, as a potential actor in reducing the number of people without bank accounts and, thus, helping to eliminate a significant barrier to asset accumulation in Puerto Rico.

IV. The Credit Union Sector in Puerto Rico

A. Synopsis of the History of the Cooperative Movement in Puerto Rico

The origins of the cooperative movement in Puerto Rico can be traced back to 1873, when the artisan Santiago Andrade together with a group of other hard working Puerto Ricans formed a mutual help society called "Los Amigos del Bien Público." The purpose of this entity was to provide affordable health care to its members. *Los Amigos del Bien Público* became quite popular and in addition to health services by 1893 it was offering loans to its members.[40] This cooperative ceased operations in 1958.

Like any other social movement, the cooperative sector in Puerto Rico has experienced waves of institutional building followed by periods of consolidation, which in turn have been followed by further periods of institutional ferment. In the late 1890s and early 20th century prominent Puerto Rican leaders, such as José Celso Barbosa and Rosendo Matienzo Cintrón, advocated the development of the cooperative sector in Puerto Rico. Their efforts culminated with the enactment in the 1920s of legislation to stimulate, structure and regulate the cooperative sector for the first time in Puerto Rico.[41]

The initial legislation, however, suffered from numerous deficiencies that impeded the full development of the cooperative sector in Puerto Rico.[42] It was not until the 1940s, under the aegis of Luis Muñoz Marín and with the cooperation of prominent leaders of the international cooperative movement, such as Father Joseph A. MacDonald of the St. Francis Xavier University in Antigonish, Nova Scotia, that the cooperative movement in Puerto Rico experienced significant institutional growth and development.

The period between 1945 and 1970 witnessed the enactment of truly ground-breaking legislation for the cooperative movement in Puerto Rico. Among the most significant laws enacted during this period we find the following:

- Act 291 of April 9, 1946, known as the Puerto Rico General Law Regarding Cooperative Societies, sets forth the first comprehensive regulatory scheme for cooperatives in Puerto Rico. Among other things, this Act allows for the creation of cooperatives in any economic sector, adopts the cooperative philosophy as a guide to the public policy of the government of Puerto Rico, sets forth a uniform process for formation, governance, supervision, regulation and dissolution of cooperatives, and clarifies the tax exempt status of cooperative enterprises.
- Act 10 of July 1, 1947, enacted specifically for the regulation of credit unions. This Act is discussed in section IV.B below.

[40] Msgr. Antulio Parrilla Bonilla, *Cooperativismo: Teoría y Práctica*, (San Juan: Editorial Nosotros, 1985) p.274.
[41] See, for example, Act 3 of May 6, 1920; Act 70 of August 4, 1925; Act 168 of May 11, 1938; and Act 265 of May 15, 1938.
[42] Parrilla, *Cooperativismo: Teoría y Práctica, supra* note 40 at 298-299.

- Act 209 of May 3, 1951 created the first *Banco de Cooperativas de Puerto Rico*, which was operational until 1966 when it was substituted by the *Banco Cooperativo*.
- Act 4 of May 1, 1957 created the *Administración de Fomento Cooperativo*, a government agency with the mandate to strengthen and develop the cooperative sector in Puerto Rico. This agency is also responsible for coordinating government efforts aimed at the cooperative sector.
- Act 84 of June 26, 1959, allows the creation of cooperatives to provide insurance services in Puerto Rico.
- Act 88 of June 21, 1966 created the new *Banco Cooperativo*, which is still in existence today, to serve as a kind of central bank/clearinghouse for credit unions in Puerto Rico.

This period of intense institutional building was followed by a period of institutional consolidation and reassessment. Already by the early 1970s, Monsignor Parrilla wrote that a thorough re-examination of the cooperative movement was necessary in order to enable its future growth.[43] However, it was not until the 1990s and the early years of the 21st century that this call to further action was heeded. During this period we witnessed the enactment of the following legislation:

- Act 6 of January 15, 1990, which enabled credit unions to offer new products and services, such as checking accounts and credit cards.
- Act 50 of August 4, 1994, which superseded Act 291 of April 9, 1946, completely overhauled the general statutory framework governing cooperatives in Puerto Rico.
- Act 114 of August 17, 2001 created a new agency to insure deposits and regulate the credit union sector.
- Act 198 of August 18, 2002, creates the Cooperative Investment Fund, which is intended to promote the creation of new cooperative enterprises by providing "equity" financing. Funds contributed by existing cooperatives will be matched by the government of Puerto Rico up to an amount of $25 million.
- Act 220 of August 29, 2002, creates a cooperativism office in the Puerto Rico Department of Education, to foster the creation of cooperative enterprises in public schools and the communities where they are located and to promote the creation of youth-oriented cooperative enterprises.
- Act 255 of October 28, 2002, which grants significant new powers to credit unions. This Act is analyzed in Section IV.B.4 below.

All this legislative activity is evidence of the support the government of Puerto Rico has provided, with some significant fluctuations, to the cooperative sector over the last 50 years.

[43] See Parrilla, *supra* note 40 at 328-341.

Notwithstanding that official support, the cooperative sector today remains a modest, albeit important, contributor to the Puerto Rican economy. Unfortunately, it falls quite short of the objective set forth in the *Propósito de Puerto Rico*, which projected the contribution of the cooperative sector to total economic activity in Puerto Rico at 25% of GNP by the end of the 1970s.[44]

Table 2 below, sets forth a functional breakdown of the cooperative sector in Puerto Rico as of December 31, 2003. As of that date there were 252 cooperatives in operation in Puerto Rico, with assets in excess of $7 billion and providing employment to more than 6,000 Puerto Ricans. The most important sectors were: (1) credit unions, (2) insurance, (3) consumption, (4) transportation, and (5) housing.

[44] Preamble of Act 88 of June 21, 1966.

Table 2
Cooperatives in Operation
as of December 31, 2003

Sector		Number	Members	Total Assets	Employment
Retail		29	72,636	$27,283,921	623
	Supermarkets	2	45,947	$15,658,539	386
	Gas Stations	7	5,271	$5,561,638	50
	Pharmacies	4	11,240	$3,621,661	49
	Cafeterias	15	9,347	$2,152,217	136
	Farm Products	1	831	$289,865	2
Wholesale Commerce		4	183	$1,938,085	21
Agriculture		9	878	$6,909,851	37
	Production/Marketing	1	215	**	**
	Fisheries	4	92	**	**
	Agroindustrial	4	571	$6,909,851	37
Manufacturing		10	219	$6,241,250	382
Hospitals		1	373	$8,119,488	180
Parking Lots		4	2,255	$476,473	18
Insurance		2	376	$836,360,000	891
Transportation		16	918	$14,202,506	952
	Trucking	8	314	$10,424,363	376
	Taxis	5	405	$1,141,073	312
	Tours	3	199	$2,637,070	264
Housing		20	4,625	$54,346,831	128
Credit Unions		143	870,511	$5,837,285,626	2,892
Banco Cooperativo		1	110	$325,000,000	65
Other		13	2,746	$3,571,348	143
	Total	**252**	**955,830**	**$7,121,735,379**	**6,332**

Source: Administración Fomento Cooperativo

** Not Available

- **Credit Unions** – We present a full profile of the credit unions in the next section. However, it is useful to provide some preliminary data here as an indication to the reader of the importance of credit unions in relation to other sectors of the cooperative movement. As of December 31, 2003, credit unions accounted for 56.75% of all cooperatives in operation in Puerto Rico, 91.07% of all members of cooperative enterprises, 81.96% of total assets and 45.67% of total employment generated by the cooperative sector.
- **Insurance** – Puerto Rico has two insurance cooperatives, the *Cooperativa de Seguros de Vida* (COSVI) and the *Cooperativa de Seguros Múltiples*. Membership is restricted only to other cooperatives, thus, insurance cooperatives account for only 0.04% of all membership. However, the insurance cooperatives account for 11.74% of total assets and 14.07% of all employment generated by the cooperative sectors. Furthermore, these cooperatives had gross revenues of $310,000,000 in 2003, which positions them as the strongest insurance providers in the island.
- **Retail** – The retail sector, which consists mostly of supermarkets, cafeterias, gas stations and pharmacies, accounted for 11.51% of all cooperatives in operation, 7.60% of aggregate membership in cooperatives, 0.38% of total assets, and 9.84% of all employment.
- **Transportation** – The transportation sector, which consists of cargo delivery (trucking), taxis, and tour operators, accounted for 6.35% of all cooperative enterprises, 0.10% of all membership, 0.20% of total assets, and 15.03% of all employment in the cooperative sector. This sector is particularly important for the Puerto Rican economy for two reasons. First, Puerto Rico imports a significant amount of its raw materials and consumption goods. Being an island, cargo arrives to Puerto Rico mostly in large container ships. Overland transportation is critical for the efficient delivery of these products from the ports to multiple manufacturing parks and warehouses across the island. Second, the tourism sector, which represents 6% of Puerto Rico's GNP, relies on taxis for the transportation of tourists.
- **Housing** – This sector accounted for 7.94% of all cooperatives in operation in 2003, 0.48% of all members, 0.76% of total assets and 2.02% of all employment.

Accordingly, the credit union segment is by and large the most significant sector in the cooperative movement in Puerto Rico. As we shall see in the next section, it is precisely this significance which makes credit unions a good vehicle for reaching the unbanked and underbanked population in Puerto Rico.

B. Profile of Credit Unions in Puerto Rico

1. Basic Statistics

As of March 31, 2004, there were 140 credit unions (*cooperativas de ahorro y crédito*) in operation in Puerto Rico, with total assets of $6,138,550,954 and 854,223 members. Since the year 2000, the total number of credit unions in operation has declined by 17, or 10.8%, from 157 in March 2000 to 140 in March 2004. Of these 140 credit unions, 71 have membership restrictions (usually limited to employees of a corporation or bona fide members of a professional group, such as doctors or teachers) and 69 have no membership restrictions.

Between March 2000 and March 2004 the total amount of assets held by Puerto Rico credit unions increased $1.721 billion, or 38.9%, from $4.418 billion to $6.139 billion.[45] Credit union assets consisted of $3.552 billion in loans (57.85% of total assets), $1.780 billion in deposit accounts and certificates of deposit (28.99% of total assets), $306 million in negotiable securities (4.98% of total assets), $230 million in cash (3.74% of total assets), $119 million of land and other real property (1.93% of total assets), $111 million in shares of other cooperative enterprises (1.80% of total assets), $28 million of equipment and other personal property (0.45% of total assets) and $86 million of other assets (1.40% of total assets).

Total loans outstanding made by credit unions increased $501 million, or 16.4%, from $3.051 billion in March 2000 to $3.552 billion in March 2004. The loan portfolio of credit unions consisted of $1.974 billion of personal loans (55.57% of total loans), $949 million of mortgage loans (26.72% of total loans), $374 million in car loans (10.54% of total loans), $109 million in credit card balances (3.08% of total loans) and $145 million of other loans (4.09% of total loans).

On the liabilities side, credit union liabilities consisted of $4.442 billion of client deposits, $81 million in accounts payable, and $125,000 in other liabilities.

In terms of deposits, during the last four years total deposits in Puerto Rico credit unions have increased $1.320 billion, or 42.30%, from $3.120 billion in March 2000 to $4.442 billion in March 2004. Deposits consist of deposit accounts (which could be checking and/or saving accounts) with an aggregate balance of $2.238 billion (50.39% of total deposits), certificates of deposit in the amount of $1.328 billion (29.92% of total deposits), inter-credit union deposits and certificates of deposit of $617 million (13.89% of total deposits), checking accounts of $68.72 million (1.55% of total deposits) and other deposits of $189.02 million (4.25% of total deposits).

Thus, as of March 2004, the average credit union had approximately $44,000,000 in assets and 6,100 members. In terms of deposits, most of its funds were sourced from members' deposit accounts (50.3%), followed by certificates of deposit (30%) and deposits from other cooperatives (14%). The loan portfolio of the average credit union consisted mostly of personal loans (56%), followed by mortgages (27%) and vehicle loans (10%).

Average figures, however, conceal widespread variation in credit union size, assets, and number of members. Credit unions range in asset size from a low of $150,000 for the

[45] All information regarding Puerto Rico-based credit unions in this section is from the report entitled *Análisis de Información Estadística al 31 de marzo de 2004*, prepared by COSSEC. This report is available from COSSEC's website at http://www.cossec.com/PDF/est_coop.pdf.

smallest credit union to assets of over $400,000,000 for the Arecibo credit union (COOPACA). In terms of number of members, credit union membership ranges from 46 members at the smallest credit union to over 79,000 at COOPACA.

Aggregate figures also conceal disparate trends in the concentration and distribution of assets and members among Puerto Rico credit unions. For example, the 20 largest credit unions in Puerto Rico, which constituted 15% of all credit unions in operation as of March 31, 2004, hold 53% of total credit union assets, account for 51% of credit union members and employ 47% of all credit union employees. (See Table 3 below). Therefore, the other 120 credit unions, which represent 85% of all credit unions, hold only 47% of total assets, account for 49% of credit union members and employ 53% of all credit union employees. These disparities in the concentration of assets, members and employees, highlight the fragmentation that has traditionally characterized the cooperative sector in Puerto Rico.[46]

[46] Estudios Técnicos, *Movimiento Cooperativo: Hacia una Visión Estratégica*, 16 Abril 1996, p.8; and Dr. Francisco A. Catalá, "Movilización de Recursos Locales: El Caso de la Economía Cooperativa" in *Futuro Económico de Puerto Rico*, Francisco E. Martínez, compilador, (Río Piedras: Editorial de la Universidad de Puerto Rico, 1999) p. 398.

Table 3
Top 20 Largest Credit Unions in Puerto Rico
By Amount of Total Assets
As of March 31, 2004

Credit Union	Total Assets	Number Of Members	Number of Employees
ARECIBO (COOPACA)	$407,150,178	79,077	196
RINCON	330,829,900	14,407	37
AGUADA	255,806,071	24,324	45
VEGA ALTA	230,046,166	34,901	105
DR. MANUEL ZENO GANDIA	224,282,905	37,692	60
ISABELA	212,293,225	29,145	51
BARRANQUITAS (CREDICENTRO)	179,543,074	18,177	66
MANATI	140,089,670	22,413	83
SAN RAFAEL DE QUEBRADILLAS	134,431,028	18,800	68
MAUNABO (MAUNA - COOP)	122,088,470	13,882	64
MEDI – COOP	120,596,222	5,805	20
CAMUY	108,050,927	10,819	40
CABO ROJO	107,055,981	13,636	38
ROOSEVELT ROADS	106,419,495	15,020	62
LAS PIEDRAS	102,847,440	17,189	36
LARES Y REGION CENTRAL	101,119,937	17,240	55
LA SAGRADA FAMILIA	98,174,416	14,821	66
SAN JOSE	96,986,596	20,839	49
ABRAHAM ROSA	93,555,417	10,780	37
HATILLO	93,180,946	12,869	42
Total	**$3,264,548,064**	**431,836**	**1,220**
% of Total Market	**53%**	**51%**	**47%**

Source: COSSEC

In comparison, as of the second quarter of 2003, commercial banks in Puerto Rico had total assets of $57.938 billion, consisting of $39.023 billion in loans (67.35% of total assets), $14.748 billion in investments (25.45% of total assets), $2.155 billion of cash and cash equivalents (3.71% of total assets) and $2.730 billion of other assets (4.71% of total assets). [47]

The commercial banks' loan portfolio of $39.023 billion consists of $20.888 billion in loans secured by real property (53.52% of total loans), $11.187 billion in loans to commercial and industrial entities (28.66% of total loans), $5.751 billion in personal loans (14.73% of total loans), and $1.197 billion in other loans (3.06% of total loans).

[47] All information in this section regarding commercial banks was obtained from the website of the Office of the Commissioner of Financial Institutions. This information is available at http://www.ocif.gobierno.pr/html/sif.html.

On the liabilities side, commercial bank liabilities consist of $40.544 billion of client deposits, $13.831 billion of other liabilities (accounts payable and short and long term debt), and $555 million of 936 funds.

In terms of deposits, commercial banks had total deposits of $40.544 billion, consisting of $20.373 billion of certificates of deposit (50.24% of total deposits), $8.387 billion of checking accounts (20.68% of total deposits), $8.124 billion of savings accounts (20.03% of total deposits) and $3.660 billion of public funds on deposit by government entities (9.02% of total deposits).

In contrast, the 9,529 federally insured credit unions had total assets as of June 30, 2003 of $599.226 billion, consisting of $353.785 billion in loans outstanding (59.04% of total assets), $157.193 billion in investments (26.23% of total assets), $65.933 billion in cash and equivalents (11.00% of total assets), and $22.315 billion in other assets (3.72% of total assets).[48]

The loan portfolio of federally insured credit unions consisted of $107.911 billion in first mortgage real estate loans (30.5% of total loans), $77.222 billion in used vehicle loans (21.8% of total loans), $60.263 billion in new vehicle loans (17.0% of total loans), $46.762 billion in other real estate loans (13.2% of total loans), $20.481 billion in unsecured credit card loans (5.8% of total loans), $20.416 billion in other unsecured loans (5.8% of total loans), $19.247 billion in other loans to members (5.4% of total loans), and $1.483 billion in leases receivable (0.4% of total loans).

On the other side of the ledger, the liabilities of federally insured credit unions consisted of $521.182 billion of deposits, $9.163 billion of borrowings, $5.028 billion of accounts payable and $554 million of other liabilities.

In terms of deposits, federally insured credit unions had total deposits of $521.182 billion, consisting of $189.030 billion of regular share accounts (36.26% of total deposits), $120.344 billion of share certificates/certificates of deposit (23.09% of total deposits), $94.728 billion of money market shares accounts (18.17% of total deposits), $64.013 billion of share draft accounts (12.28% of total deposits), $45.515 billion of IRA/Keough accounts (8.73% of total deposits), $6.555 billion of other member deposits (1.25% of total deposits), and $1.197 billion of non-member deposits (0.22% of total deposits).

A brief analysis of this data reveals some trends worthy of note. First, notwithstanding the decrease in the number of credit unions in Puerto Rico during the last four years, credit unions have demonstrated substantial increases in total assets, loans and deposit activity, which is indicative of the relative strength of the sector.

[48] All information regarding federally insured credit unions in this section is from the report entitled 2003 Mid-Year Statistics for Federally Insured Credit Unions, prepared by the National Credit Union Administration (NCUA). This report is available from NCUA's website at http://www.ncua.gov/ReportsAndPlans/statistics/Midyear2003.pdf.

Second, credit union membership, which stands at 854,223, or approximately 31.44% of the population of Puerto Rico older than 18, is indicative of the attractiveness of credit unions to a large segment of Puerto Rican society. Even if we reduce the number of members by 25% to account for multiple memberships, approximately 24% of the adult population, almost 1 in every 4, is a member of a credit union in Puerto Rico.

Third, it is interesting to compare the composition of the loan portfolios of the three types of entities. More than half of the outstanding loans made by credit unions in Puerto Rico were personal loans, which are used mostly to finance personal consumption. Commercial banks, on the other hand, have financed the acquisition of real property and the operations commercial and industrial concerns. In other words, commercial banks have concentrated on financing the acquisition of real assets, that is, they are financing investment, and the productive side of the Puerto Rican economy. Federally insured credit unions, in contrast with both local credit unions and commercial banks, have emphasized the vehicle financing and first mortgages, instead of financing consumption or on-going operations of industrial or commercial firms.

Fourth, credit unions are a small but significant part of the Puerto Rico financial system. In terms of personal financial assets, Puerto Ricans held $31.016 billion in financial assets as of the end of fiscal year 2002. Of that total, $18.592 billion, or 59.9%, were deposits held in commercial banks, $4.843 billion, or 16%, were deposits in credit unions, and $4.882 billion, or 16%, represented holdings in public pension funds.[49] However, the credit union's share of total financial assets held by Puerto Ricans is less significant we when we include other financial assets held by local residents. For example, the UBS office in Puerto Rico estimates that approximately $45 billion in assets is held by Puerto Ricans in offshore accounts and are mostly invested in federal agency securities. [50] If we include these offshore assets, the share of credit union deposits drops to 6.3% of total financial assets.

In terms of net income for the financial sector, however, the contribution of credit unions is less significant. Total internal net income for the financial sector in Puerto Rico for fiscal year 2002 was $3.132 billion. Of that total, $1.675 billion, or 53%, was generated by commercial banks, $69.9 million, or 2.23% was generated by credit unions and $1.387 billion, or 44.29%, was attributed to other financial institutions.[51]

Finally, credit unions have invested only 1.8% of their assets in other cooperative enterprises in Puerto Rico, which is indicative of the eminently conservative nature of credit union management in Puerto Rico.

[49] Junta de Planificación, *Informe Económico a la Gobernadora 2002*, Capitulo VIII, p.16.
[50] Memorandum from Miguel A. Ferrer to Miguel A. Soto Class, February 6, 2003, on file at the Center for the New Economy.
[51] Junta de Planificación, *supra* note 49, Capitulo VIII, p.14.

2. Geographic Presence

Credit unions have established a presence all around the island. Every municipality or township (*municipio*) in Puerto Rico has at least one credit union, and as shown in Table 4 below, the distribution of credit unions is fairly even across the geographic regions of Puerto Rico.

Table 4
Credit Union Data
By Geographic Region
As of June 30, 2003

Region	Total Assets	Number of Credit Unions	Total Members	Non-Members Served	Total Employees
San Juan (Metro)	713,000,000	54	105,827	36,069	362
San Juan (Suburban)	931,000,000	22	135,464	94,480	484
Arecibo	1,426,000,000	15	252,659	98,070	695
Caguas	756,000,000	15	135,196	67,551	413
Mayaguez	1,264,000,000	18	147,850	33,322	364
Ponce	637,000,000	18	92,450	39,481	278
Total:	**$5,727,000,000**	**142**	**869,446**	**368,073**	**2,596**

Source: COSSEC

In our view, credit unions are well positioned to target the unbanked population across the island, especially in the greater San Juan area, where there are 77 credit unions with total assets in excess of $1.600 billion. The San Juan area, as we mentioned in Section II.A above, has the largest concentration of unbanked households in Puerto Rico. Thus, this strong presence in San Juan could allow credit unions to intensively target these households, which are otherwise not served by the financial services industry.

3. Sociocultural Characteristics

The typical member of the credit union is a resident of the town or region where the credit union operates. According to credit union management we interviewed, most of their clients come to the credit union because of the personal treatment they receive and, secondly, because of the attractive offers that the credit union is able to provide. Management also estimates that between 20 to 40 percent of their new clients are persons who have had no previous experience with a formal provider of financial services. Thus, a significant portion of the growth in credit union membership can be attributed to tapping the unbanked market, even if in a fortuitous fashion.

In general, credit unions have smaller advertising budgets than commercial banks. Therefore, they rely primarily on attracting residents of the geographic area/region in which the credit union operates, by offering a highly personalized level of service to their clients.

By and large, according to management interviews, credit unions perceive commercial banks as their main competitors, followed by check cashing outlets and small loan companies (*financieras*). Most managers, however, were confident that the high quality personal service they offer to their clients gave credit unions a significant competitive advantage over most commercial banks. Significantly, credit union management did not generally regard other credit unions as competitors.

Credit unions have displayed significant flexibility and creativity in helping their clients obtain their financial goals. For example, lack of free and clear title is a significant problem in Puerto Rico, especially among low and medium income households, where property oftentimes is acquired through adverse possession or informally transferred between family and relatives. In light of persistent difficulties in securing property titles by local mortgage applicants, a credit union in a small mountain town of the island has been willing to offer personal loans to clients to finish construction of their homes while they finalize the paperwork to obtain free and clear title to the property. Once the client finalizes construction and obtains title to his property, then the credit union underwrites a home mortgage loan which the client can use to repay the personal loan.

Other credit unions have worked with employees facing layoffs due to the closing of a local manufacturing plant to enable these workers to form cooperatives and buyout the assets from the company closing shop in their region. Still other credit unions have initiated programs targeting the residents of special communities throughout Puerto Rico to enable them to form small cooperatives which operate in, and provide services to, their community.

Thus, our impression is that in many regions of Puerto Rico, especially in the smaller towns, credit unions have become part and parcel of those strong social networks that the poor have developed to deal with the problems presented by daily existence. In fact, it could be argued that credit unions, in certain areas of the island, have become a bridge between those informal networks of the poor, through which they implement their survival strategies, and the formal social institutions through which they must operate, which traditionally are not connected to this informal world.

One of the key principles of all credit unions is to assist their clients by offering basic financial education. These financial education programs, however, vary significantly in coverage and scope. Some credit unions sponsor radio shows or publish newspaper articles in regional periodicals which cover issues such as savings, credit management, and other credit-related matters. Others have small programs oriented mostly to management and employees. This appears to be an area where cooperation among credit unions could produce significant positive results over the short term.

Most credit unions also appear to be significantly involved in sponsoring cultural and sports activities in their communities. These programs, while significant, are often executed on an ad hoc basis and their overall impact is therefore diluted. The upside of these programs, in terms of reaching the unbanked, is that credit unions have developed a considerably positive brand image in their communities and the people have invested a certain amount of trust in credit unions. In addition, credit unions have become, in many cases, a focus of social activity in their communities, which offers an additional advantage when targeting the unbanked population.

Finally, all credit union managers we interviewed expressed interest in forming joint ventures or working groups to develop a product specifically targeted to the unbanked population and to craft a financial education curriculum which could be implemented throughout Puerto Rico via other credit unions.

In our opinion, this willingness to work and be flexible with clients, in addition to credit unions' positive image in the community, their social mission anchored in cooperative principles, their importance as cultural/social centers, their experience, albeit unstructured, in offering services to the unbanked, their relative financial strength, their geographic presence and the new legal powers granted credit unions by Act 255, endow credit unions with the potential to effectively target the unbanked population in Puerto Rico.

4. Legal Framework for Formation, Governance, Administration and Operation

Act 10 of 1 July 1947 established the legal regime for credit unions in Puerto Rico. The intent of Puerto Rican legislators at that time was to emulate the credit union system in the United States.[52] This initial legislation, however, imposed severe restrictions on the operations of credit unions in Puerto Rico. Under this initial regime, credit unions could not offer services to non-members, a restriction that severely limited ability of credit unions to achieve economies of scale. Second, this law imposed a cap on the maximum investment by members, which limited the principal source of capitalization, and hence growth, of credit unions. This law also limited credit unions lending to personal loans, a restriction which further limited their ability to offer competitive financial products.[53]

Subsequent legislation partially addressed some of these limitations. For example, Act 1 of June 15, 1973, allowed credit unions to offer services to non-members and eliminated the maximum cap on investment by members. Act 1, however, limited credit unions' ability to offer loans to non-members by requiring 100% cash collateral, in the form of

[52] Parrilla, *Cooperativismo: Teoría y Práctica*, *supra* note 40 at 303.
[53] Ms. Irma Hilerio, *Legislación para El Desarrollo Cooperativo Puertorriqueño*, 25 May 2004, presentation by the Executive Director of the Administración de Fomento Cooperativo del Estado Libre Asociado de Puerto Rico, on file at the Center for the New Economy.

deposits, as security for those loans. Act 99 of June 4, 1980, created the Share and Deposit Insurance Program (PROSAD), with the objective of insuring credit union depositors up to the amount of $40,000. This law also established economic solvency requirements which had to be satisfied in order to qualify for government insurance. Those credit unions that did not meet the requirements were obligated to cease operations.

However, it was not until 1990, with the enactment of Act 6 of January 15, 1990, that credit unions were granted broad authority to offer additional products and services. Act 6 allowed credit unions to offer checking accounts and credit cards, to acquire and manage automated teller machines, and to affiliate with electronic exchange networks. This law also required for the first the creation of a core capital reserve, the equivalent of Tier I capital for banks, and required that non-performing loans be written off the balance sheet with a corresponding charge to operational earnings.

Since 2001 significant new legislation has been enacted for the credit union sector in Puerto Rico. First, Act 114 of August 17, 2001, created the *Corporación para la Supervisión y Seguro de Cooperativas* (COSSEC) to regulate the credit union sector and to insure depositor accounts up to a maximum of $100,000. Second, Act 255 of October 28, 2002, significantly expanded the products and services that could be offered by credit unions and established rigorous capital requirements for all credit unions. Given the importance of this law, we proceed to analyze it in some detail.

a. Policy Objectives

According to the preamble of Act 255, it is the "public policy of the Commonwealth to steer Puerto Rico's economic and social development in accordance with the social justice, empowerment and democratic control principles characteristic of the cooperative movement." In addition, the legislators recognize the "importance of the cooperative sector for the social and economic development of Puerto Rico" and, thus, "encouraging the growth and strengthening of the cooperative movement" is a "highly important" public policy objective.

In that context, the legislature proceeds to set forth its express legislative objectives in enacting Act 255:

- To allow credit unions to offer products and services under conditions applicable to other providers of financial services.
- To facilitate the flow of financial resources for the financing of productive activity, particularly small and medium sized businesses.
- To enable the creation of corporate structures to allow credit unions to participate in activities permitted to other providers of financial services.
- To foster the just, efficient and effective regulation of the credit union sector.
- To advance the professional development of credit union directors, management and employees.

- To promote the harmonious collaboration between management and their supervisory entities.
- To facilitate the economic integration of the credit union sector with other productive sectors.
- To promote the integration of the credit union sector, especially through structures to facilitate operational integration.

The preamble concludes with the statement that this "cutting edge" legislation is intended to satisfy the demands for "operational flexibility and for competitive equality which have been made by the credit unions through the years, within a framework of administrative and financial prudence".

b. Formation of Credit Unions

Act 255 provides that any 5 persons of legal age can act as incorporators of a credit union in accordance with the terms and conditions set forth therein. In general, the process of incorporation of a credit union is very similar to that for a regular corporation. However, there some important differences. For example, prior to filing the documents of incorporation, the persons seeking to establish the new credit unions must undergo an orientation from either Fomento Cooperativo or the League of Cooperatives covering the financial management requirements applicable to the management of a cooperative and the general cooperative principles. Additional requirements for formation include certification by COSSEC that a new credit union is necessary, an initial capitalization of at least $50,000, and have at least 35 members within the first six months of operation.

c. Governance and Administration

Credit unions are allowed to issue preferred and common stock in various classes and series. Holders of preferred shares are entitled to a preference in the payment of dividends in relation to holders of common shares. Holders of preferred shares cannot vote or participate in member meetings and cannot be elected to any of the credit union's management committees (unless they also own common shares).

Holders of common shares are entitled to receive the payment of common dividends, to vote and participate in member meetings and to hold management and other positions in the credit unions.

Act 255 sets forth a uniform governance structure for credit unions. The members (holders of common shares) meet annually to select a board of directors. According to our interviews, in practice, credit union directors are usually "prominent persons" from the locality or the region where the credit union is located, tend to be older, and to have (or have had) public sector jobs.

The board of directors supervises all operations of the credit union and selects the executive president of the credit union. The board may also form committees to deal address special issues, such as member education or credit matters.

The executive president hires the senior management of the credit union. In many credit unions employees begin as cashiers and gradually move up the ladder. Based on our observations, credit union employees are residents of the town or the region where the credit union operates and a significant portion of them has worked in commercial banks.

d. Capital and Capitalization

Article 6 of Act 255 sets forth the capital and capitalization requirements for credit unions in Puerto Rico. The Act requires credit unions to maintain an initial minimum "core capital" of 3% of assets at risk. This requirement increases gradually until it reaches 8% of assets at risk by December 31, 2007.

The amount of assets at risk is calculated pursuant to a formula which assigns different weights to various asset classes according to their risk. These weighs fluctuate from 0% for cash to 100% for personal loans. Credit unions which do not satisfy these capital requirements have to submit a capitalization plan for approval by COSSEC. If COSSEC does not approve the proposed capitalization plan or if the credit union is found to be in substantial breach thereof, then COSSEC could order the merger of such credit union with another credit union or direct its liquidation.

e. Regulation

COSSEC is the government entity in charge of supervising and regulating credit unions in Puerto Rico. It combines both regulatory oversight and depositary insurance functions in one agency. Act 114 of August 17, 2001 grants COSSEC broad regulatory and supervisory powers over credit unions. According to the statute, COSSEC has the:

- Power to order the examination and audit of all the operations of credit unions in Puerto Rico.
- Duty to look after and ensure the liquidity and solvency of credit unions.
- Power to study, design, enact, construe and interpret rules and regulations regarding the operations of credit unions in Puerto Rico.
- Power to accept and investigate complaints filed by credit union customers.
- Power to supervise and regulate the investments made by credit unions.
- Obligation to watch out for and protect the interests of credit union shareholders.

COSSEC insures deposits and common shares held by members up to an amount of $100,000. COSSEC is capitalized from the following sources: (1) each credit union is required by law to contribute every year an amount equal to 1% of its total deposits and shares outstanding; (2) each credit union must also pay an annual insurance premium, which is based on its risk rating according to the CAEL system; (3) income and interest generated by COSSEC's investment of its capital; and (4) charges, fees and penalties imposed by COSSEC.

COSSEC has statutory authority to order the receivership and liquidation of any credit union, and it also must review and approve any merger of credit unions or the acquisition of one credit union by another.

f. Authorized Activities for Credit Unions in Puerto Rico

Act 255 allows credit unions in Puerto Rico to offer the following services and products:

- **Loans and Financial Services to Members**
  - Accept, receive and manage any type of deposits from persons and public and private entities and offer all those depositary services which can be offered by ordinary depositary financial institutions, including:
    - Savings accounts, checking accounts, certificates of deposit and other instruments, with or without interest;
    - Providing Electronic Fund Transfer facilities or services and other electronic banking services, including debit cards and any other electronic payment methods; and
    - Managing deposits and individual retirement accounts as well as other funds in trust.
  - Make any type of financing, including:
    - Personal loans or lines of credit, with or without collateral;
    - Car loans;
    - Loans for the acquisition of personal property (*bienes muebles*), with or without a security interest;
    - Mortgage loans of any type;
    - Student loans guaranteed by any agency of the US or PR government;
    - Credit card services;
    - Loans for the financing of insurance premiums;
    - Collateralized commercial loans; and
    - Financing lease agreements for personal property.
- **Loans and Financial Services to Non Members**
  - Every cooperative may offer the following products and services to non-members:

- Personal loans up to the maximum amount and in accordance with the terms and conditions allowed by the Small Personal Loan Companies Act of Puerto Rico; and
- all the financial services that may be provided to members, provided that any loans offered to nonmembers may not exceed the amount of liquid assets that the debtor maintains on deposit with the cooperative or other assets that guarantee 100% of the loan.

❖ **Other Financial Activities**

- Make deposits in other cooperatives, in the Puerto Rico Cooperative Bank and in commercial banks doing business in Puerto Rico;
- Purchase shares and other securities issued by cooperatives operating in Puerto Rico;
- Make loans to other cooperative entities doing business in Puerto Rico;
- Borrow money from any person, entity or public or private agency, provided that such borrowings may not exceed 25% of the capital of the cooperative;
- Accept, endorse, discount, legalize and issue promissory notes, letters of credit, certificates of deposit and other negotiable instruments;
- Buy and sell money orders, travelers checks, accept securities for deposit, manage loans, buy and sell postage stamps, internal revenue stamps, prepaid telephone cards and other similar goods and services;
- Buy and sell bonds and other securities issued by the government of Puerto Rico, the United States or any state of the United States;
- Establish or affiliate with one or more associations, corporations or networks which offer financial services, including electronic fund transfer networks or associations;
- Operate a trust department;
- Buy and hold shares of common stock and debt obligations issued by:
  - Federal National Mortgage Association;
  - Federal Home Loan Mortgage Corporation;
  - Government National Mortgage Association;
  - Student Loan Marketing Association;
  - Federal Land Bank;
  - Federal Intermediate Credit Bank; and
  - The Bank for Cooperatives.
- Alienate or lease the personal property necessary to carry out the business of the cooperative;
- Accept public funds for deposit;

- Sell, solicit, offer or market insurance products in Puerto Rico;
- Engage in those activities or financial services necessary or convenient to strengthen its competitive position as a financial intermediary that operates in a deregulated environment;
- Act as sole incorporator for subsidiaries or affiliated entities;
- Undertake any and all acts and operations necessary to realize the activities for which the cooperative has been organized; and
- Engage in any other activity which COSSEC deems to be incidental to the operations of the cooperative.

- **Investments in Subsidiaries, Affiliates and Other Cooperative Enterprises**
  - **100% Owned Subsidiaries –** Cooperatives are authorized to undertake any of the permitted activities through wholly-owned subsidiaries.
  - **Investment in Financial Enterprises of the Second Degree** – Two or more cooperatives may establish, organize and invest in institutions or entities dedicated to offering financial services to other cooperatives or other persons.
  - **Investments in Non Financial Cooperative Enterprises** – Financial cooperatives may sponsor, promote, facilitate the financing of, invest and participate, as members or as holders of preferred stock, in cooperative enterprises that provide multiple services or that are dedicated to commercial, industrial or agricultural activities or that contribute in any other form to the creation of jobs, or the development of the cooperative movement.
- **Restriction on Loans** – Financial cooperatives may not make loans to for profit corporations, partnerships, associations, or other entities, except in the case of commercial loans to small and medium size businesses controlled by persons that are members of the lending credit union or in the case of projects or economic sectors with the potential for creating new jobs or which are deemed to be in the public interest.

5. Products Currently Offered by Credit Unions in Puerto Rico

Most credit unions have not taken advantage of the powers granted by Act 255 and while they offer a wide spectrum of financial services and products, there exists a gap between what Act 255 allows and what is currently offered by credit unions. According to our research, most credit unions in Puerto Rico offer the following products and service:

a. *Transactional and Savings Products and Services*

1. Share accounts – These are the accounts through which clients can become members of the credit union by purchasing shares of common stock. The minimum annual deposit is $120 and many credit unions allow clients to make this investment in monthly installments of $10 each.

2. Traditional Savings Account – This can be a passbook type account. Client funds are guaranteed up to $100,000 by COSSEC.
3. Christmas and Vacation Club Accounts – These are short term savings accounts designed to save money for summer vacations or Christmas gift expenses. They appear to be extremely popular with some clients.
4. Certificates of Deposit – Most credit unions offer short and long term certificates of deposit. The minimum amount to buy a CD fluctuates between $500 and $1,000.
5. Checking Accounts – Most credit unions offer at least one type of checking account, with many offering two or more checking products. Usually, there is a minimum balance requirement to open the account and a monthly fee is assessed if the balance is lower than a pre-established minimum.
6. Debit Card services – Many credit unions, in collaboration with the Banco Cooperativo, offer ATM debit card services to clients.
7. Direct Deposit – Most credit unions offer direct deposit services to clients.
8. Remittances – Some credit unions offer money remittance services to both the United States and foreign countries.

b. Credit Products

1. Personal Loans – Credit unions offer a wide variety of personal loans, usually partly collateralized with member shares. The maximum principal amount fluctuates from $25,000 to $40,000. Most credit unions are willing to lend up to four times the value of shares owned by a member.
2. Mortgage Loans – Credit unions underwrite traditional mortgage loans; the maximum principal amount varies according to the real estate market in the region where the credit union operates.
3. Vehicle Loans – Credit unions lend for purchases of both new and used cars.
4. Loans for Appliances – Most credit unions offer loans, usually up to $5,000, for the purchase of home appliances.
5. Non Member Loans – These are loans that are fully collateralized (100%) with the borrower's funds on deposit at the credit union.
6. Emergency Loans – Credit unions usually provide short-term loans to cover unforeseen events, such as sudden illness, property damage due to floods, etc.

7. Loans for Insurance Premiums – Most credit unions provide loans to members to cover insurance premium payments.
8. Loans for Non Profit Organizations – One interesting product offered by credit union is a special loan to non profit organizations, mostly churches. This is a niche market, mostly underserved by traditional commercial banks.
9. Credit Cards – Banco Cooperativo has negotiated with Master Card a special arrangement that allows local credit unions to offer Master Card products to their clients at a relatively low cost.

6. Challenges for the Future

Through our research we have been able to identify some areas which present shared challenges to credit unions in Puerto Rico. Among these areas are:

a. **Capitalization** – Act 255 requires credit unions to progressively increase their core capital until it equals at least 8% of assets at risk by January 1, 2008. Whether all credit unions, specially the smaller ones, will be able to meet this statutory requirement remains an open question. Failure to meet capital requirements may restrict the ability of these credit unions to engage in otherwise permissible activities, could result in regulatory intervention by COSSEC, and ultimately cause the disappearance of these credit unions, either through liquidation or merger. It should be noted here that Act 255 does provide new mechanisms, such as the issuance of preferred stock and capital obligations, for credit unions to increase their capital. This additional flexibility could provide a respite for those credit unions that have problems satisfying the statutory capital requirements.

b. **Staff Education and Training** – The preparation and experience of credit union management and workforce varies considerably. If credit unions desire to offer more sophisticated products to their clients, then they will have to uniformly improve the skills of their employees in areas like financial analysis, credit analysis and risk management. Training is an area where the *Instituto de Cooperativismo* (Cooperativism Institute) and the *Liga de Cooperativas* (Cooperative League) can assist credit unions in designing a curriculum, and offering courses, to improve the skill set of credit union employees and management. Credit union management could also benefit from obtaining advice with regard to their new powers under Act 255.

c. **Information Technology** – Advances in information technology have transformed the delivery of financial services over the last 15 years and harnessing the power of information technology has become essential to the efficient management of a financial institution. There are three broad categories of information technology systems that are critical to financial institutions: (1) client interfaces, such as automatic teller machines and Internet-based banking; (2) internal control systems, such as compliance, risk management and accounting software applications; and (3) back office systems, to keep track of settlements and execute check truncation. Credit unions in Puerto Rico differ widely in their use of and access to the latest technology. As credit unions seek to offer new highly sophisticated products they will have to adopt the appropriate technology to offer such services, manage the new risks, and keep proper internal control of their operations. This is an area where cooperation among the credit unions, in conjunction with the Banco Cooperativo, can be fruitful in reducing individual costs and the risks associated with the adoption of new technologies.

d. **Small Business Loans** – Act 255 allows credit unions to offer commercial loans to small and medium size enterprises (SMEs). This area poses both threats and opportunities for credit unions. On one hand, loaning to SMEs could be very profitable and could help credit unions to diversify their loan portfolios, which up to now are heavily concentrated on the personal consumption side. On the other hand, entering into this kind of market would pit credit unions in direct competition with commercial banks and expose credit unions to new risks. There is considerable doubt as to whether credit unions have the operational wherewithal in terms of capital, human resources and technology to manage these new risks and limit potential losses to bearable levels.

e. **Mortgage Portfolio** – In Puerto Rico there is no secondary market for mortgages underwritten by credit unions. Most large mortgage banks either (i) pool their mortgage loans and sell them through Ginnie or Fannie Mae or (ii) periodically sell mortgage loans to an affiliated financial institution (Banco Popular in the case of Popular Mortgage and Doral Bank in the case of Doral Mortgage). Securitization of mortgages effectively reduces 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. The lack of a liquid and efficient secondary market means that most credit unions have retained in their books a significant amount of mortgage loans as mortgage lending has exploded in recent years due to record low interest rates. However, in a rising rate environment these portfolios could experience significant decreases in their value due to their lower average yields. In addition, credit unions could face a liquidity squeeze as short term rates rise, increasing their funding costs, while the income they receive from their mortgage portfolios remains fixed at a relatively low rate. This conjunction of events presents an opportunity for the creation of local secondary mortgage market, either through local securitization programs, with the Banco Cooperativo in the role of Ginnie or Fannie Mae or through the creation of investment companies (i.e. mutual funds) which could issue shares to the public at large and use the proceeds to purchase mortgage portfolios from the credit unions.

f. **Challenges to Tax Exemption** – Commercial banks, both in the United States and Puerto Rico, are beginning to question the rationale for exempting credit unions from taxation. If credit unions behave like, and offer the same products as, commercial banks then it becomes difficult to justify this preferential fiscal treatment. Credit unions may be able to defend this preferential treatment by focusing on serving underserved groups and by increasing their social and community activities. In specific, in order to justify their tax exemption, credit unions could roll out products for the unbanked that commercial banks are unwilling to offer.

g. **Sacrificing Social Mission to Compete with Commercial Banks** – During our interviews, various persons expressed concern regarding the blurring of the line between the larger credit unions and commercial banks. The principal worry is that the larger credit unions may seek to grow their business by competing directly with commercial banks at the expense or to the detriment of carrying out their social mission as cooperative enterprises. In our view, these two objectives need not conflict with each other. Act 255 provides new flexibility to credit unions to enter new markets and offer new products. By taking advantage of those new powers, for example, by offering credit to small and medium size business in their region and by offering financial services to currently unserved or underserved populations, it is possible for credit unions to continue to expand while executing their social mission as part of the cooperative movement.

h. **COSSEC's Role** – Both Act 255 and Act 114 of August 17, 2001, grant COSSEC broad regulatory and supervisory powers over the credit union sector in Puerto Rico. Like any other regulatory body, COSSEC has to find and maintain a difficult balance between, on one hand, the bureaucratic tendency to micromanage and overreach and dangerous regulatory lethargy and weakness on the other. COSSEC should issue regulations pursuant to these two acts as soon as practicable and keep in sight the legislative intent to stimulate the growth of the credit union sector in Puerto Rico. In addition, by exercising both regulatory and insurance functions, COSSEC may have an incentive to act in an overly conservative manner to prevent potential calls on its capital. Credit unions right now have the potential to become a powerful economic and social force in Puerto Rico. Excessive or inefficient regulation by COSSEC could destroy this potential.

To recapitulate, we have seen that credit unions in Puerto Rico have the assets and financial capacity, geographic presence, brand name recognition, legal powers and experience to cater to the unbanked. Credit unions, however, do not currently offer any product directly to this market. We now proceed to explore some of the alternatives available to serve the unbanked.

V. Banking the Unbanked in Puerto Rico

A. Developments in the Financial Services Industry

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."[54] 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."[55]

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.[56]

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.[57]

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

[54] Stegman, *Savings for the Poor*, *supra* note 13 at 40.

[55] Seidman and Tescher, *From Unbanked to Homeowner*, *supra* note 15 at 6.

[56] Estudios Técnicos, *Movimiento Cooperativo: Hacia una Visión Estratégica*, *supra* note 46 at 54.

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

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".[58] By 2003, the number of IDAs outstanding in the United States was estimated to be between 20,000 and 50,000.[59]

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 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, 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.[60]

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.[61]

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

[58] Stegman, *Savings for the Poor*, *supra* note 13 at 129.
[59] Seidman and Tescher, *From Unbanked to Homeowner*, *supra* note 15 at 7-8.
[60] Richard L. Carrion, *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.
[61] Id.

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. As we have seen in Section II.A above, 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. According to the law 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 poliymakers about IDAs and how they can be integrated with existing welfare programs. 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.

B. Financial Products Currently Offered by Credit Unions (What We Have)

As we pointed out in Section IV.B.5 above, credit unions in Puerto Rico offer a wide variety of services to their clients, but currently they do not offer any product or service specifically designed or directly marketed to the unbanked population in Puerto Rico. However, the wide array of products currently offered by credit unions in Puerto Rico is indicative of the sophistication of the of their operations and of their potential for developing products targeted to this segment. We restate those products here to remind the reader of what is currently offered by credit unions.

1. Transactional and Savings Products and Services

- Share accounts – These are the accounts through which clients can become members of the credit union by purchasing shares of common stock. The minimum annual deposit is $120 and many credit unions allow clients to make this investment in monthly installments of $10 each.
- Traditional Savings Account – This can be passbook type account. Client funds are guaranteed up to $100,000 by COSSEC.
- Christmas and Vacation Club Accounts – These are short term savings accounts designed to save money for summer vacations or Christmas gift expenses. They appear to be extremely popular with clients.

- Certificates of Deposit – Most credit unions offer short and long term certificates of deposit. The minimum amount to buy a CD fluctuates between $500 and $1,000.
- Checking Accounts – Most credit unions offer at least one type of checking account, with many offering two or more checking products. Usually, there is a minimum balance requirement to open the account and a monthly fee is assessed if the balance is lower than a pre-established minimum.
- Debit Card services – Many credit unions, in collaboration with the Banco Cooperativo, offer ATM debit card services to clients.
- Direct Deposit – Most credit unions offer direct deposit services to clients.
- Remittances – Some credit unions offer money remittance services to both the United States and foreign countries.

2. Credit Products

- Personal Loans – Credit unions offer a wide variety of personal loans, usually partly collateralized with member shares. The maximum principal amount fluctuates from $25,000 to $40,000. Most credit unions are willing to lend up to four times the value of credit union shares held by a the member.
- Mortgage Loans – Credit unions underwrite traditional mortgage loans; the maximum principal amount varies according to the real estate market in the region where the credit union operates.
- Auto Loans – Credit unions lend for purchases of both new and used cars.
- Loans for Appliances – Most credit unions offer loans, usually up to $5,000, for the purchase of home appliances.
- Non Member Loans – These are loans that are fully collateralized (100%) with the borrower's funds on deposit at the credit union.
- Emergency Loans – Credit unions usually provide short-term loans to cover unforeseen events, such as sudden illness, property damage due to floods, etc.
- Loans for Insurance Premiums – Most credit unions provide loans to members to cover insurance premium payments.
- Loans for Non Profit Organizations – One interesting product offered by credit union is a special loan to non profit organizations, mostly churches. This is a niche market, mostly underserved by traditional commercial banks.

- Credit Cards – Banco Cooperativo has negotiated with Master Card a special arrangement that allows local credit unions to offer Master Card products to their clients at a relatively low cost.

C. Offering Financial Services to the Unbanked in Puerto Rico—the Killer Applications (What We Need)

As we noted in Section II, 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.[62]

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 study 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[63]:

- 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.

Our suggestions are based on an analysis of innovative proposals that have been put forward in other jurisdictions and constitute, in a sense, a synthesis of what could be called the "best practices" to reach the unbanked. In short, we present here to credit unions products equivalent to what in the IT sector would be called "killer applications".

While we acknowledge that implementing these recommendations will require significant effort and innovation by the credit unions because they currently do not offer any product off the shelf that can meet these requirements to reach the unbanked, it seems to us that offering them is within the realm of the possible. Credit unions in

[62] Seidman and Tescher, *From Unbanked to Homeowner*, *supra* note 15 at 11.
[63] 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.

Puerto Rico currently possess all the elements necessary—capital, operating experience, brand name, technology—to commence offering these products.

In addition, credit unions have the potential to make substantial progress in targeting the unbanked because they:

(1) Are used to offering financial education and counseling, which help overcome barriers to access;

(2) Are open to collaborating with other credit unions in developing new products for the unbanked, which helps lower R&D costs;

(3) Have a presence in every town of the island, enjoy widespread membership and have access to state of the art technology, which allows for scale; and

(4) Are non-profit entities, which gives them more leeway in term of offering new products to the unbanked population.

What is missing is the institutional leadership to focus these elements to reach the unbanked.

1. The "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;
- 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;
- Allow for additional deposits;
- Provide a basic bill payment feature for a fee (to be determined);
- Check deposits would be cleared immediately (no float);
- At the customer's option, include a prearranged savings mechanism that automatically sweeps at least $10 per month for the purchase of common shares issued by the credit union; and

- Provide the same consumer protection offered to other credit union members, that is, deposits would be insured by COSSEC up to the statutory limit of $100,000.

2. 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.[64]

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.[65] 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."[66]

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.[67] 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 to transact business anywhere that those brands are accepted, as well as through ATM and point of sale (POS) machines."[68] 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

[64] Seidman and Tescher, *From Unbanked to Homeowner*, *supra* note 15 at 22.
[65] 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.
[66] Id at 2.
[67] 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.
[68] Id. at 3.

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 credit unions, would have the following characteristics:

- Credit unions would contract with a non-bank SVC vendor to operate the cards issued by the local credit unions;
- 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 the credit union;
- 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;
- Monthly fee structure for Puerto Rico needs to be worked-out;
- 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 for the purchase of common shares in the credit union.

3. Credit Union Individual Development Accounts (IDAs)

Individual Development Accounts (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 only for 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.

We suggest that credit unions offer IDA accounts with the following characteristics:

- Account holders will be required to save a minimum of $10 a week.
- Credit union will match up in a 2 to 1 ratio up to $1,040 per year, either in cash or credit union shares. Credit union shares would be preferable for the match because they are not liquid and can be used as collateral for a loan.
- Credit unions would design and offer a financial education program for IDA account holders. Successful completion of the financial education program would be a requirement for continued participation in the IDA program.
- 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.

An IDA which included matching deposits in the form of credit union shares, would help account holders to move along the credit path by creating a link between savings and credit products given that many credit unions in Puerto Rico are willing to lend against the value of their own shares in a ratio of four to one. At the end of three year IDA period, if the account holder has deposited the maximum amount, she would have over $3,000 worth of credit union shares which she could leverage to obtain a personal loan in excess of $12,000. In terms of the credit path, our hypothetical client would have moved from saver to borrower in one step.

D. Potential for Collaboration

There are significant overhead costs for research, product development, operating systems, staff training, marketing, and education associated with increasing financial access for the unbanked and expanding the offer of financial services to lower-income clients. These significant up-front costs are a problem for two reasons. First, while a credit union's monthly recurring costs associated with administrating a low-cost account can be recovered by charging low monthly fees, recovering these initial overhead costs may result in fees that most unbanked households may be unwilling to pay.

Second, individual credit unions may be unwilling to undertake these up-front costs if the return, in the form of low-cost accounts, will be shared widely with other credit unions which did not undertake any significant costs for developing the new product. Specifically, according to Michael Barr, marketing of new products and training of bank staff "are both critical to the success of any new product; yet, given the expense and the expected low returns, they are often not fully pursued even when financial institutions decide to become involved with offering financial services to low-income customers."[69]

These obstacles can be overcome through collaboration and cooperation among and between participants in the cooperative sector, as well as through cooperation with commercial banks. Credit unions are particularly well suited for this kind of

[69] Barr, *Banking the Poor*, *supra* note 2 at 183.

arrangement because collaboration is intrinsic to their mission. The following list is only a partial enumeration of the various possibilities for cooperation that are available to credit unions and other actors:

- **Create a Cooperative Fund for Research and Development of New Financial Products** – This fund would be financed with contributions from credit unions and Banco Cooperativo. It would provide funding for market research, product development, marketing and training programs which are targeted towards increasing the supply of products and services for the unbanked. This fund could be the endowment component of a Puerto Rico Center for Financial Access Research and Innovation which would be dedicated to funding innovative research on the subject of financial access in Puerto Rico.
- **Use a Joint Venture Structure to Fund Research, Development and Marketing of new Products on a Stand Alone Basis** – Article 2.06(b) of Act 255 allows credit unions to form joint ventures for different purposes. If collaboration of the kind described above is not possible, perhaps two or more credit unions can join resources to achieve common objectives directed towards the unbanked. Strategic alliances and joint ventures have become a major feature of the business landscape in the United States and abroad. The rationales often cited for a starting joint venture include the following: (1) risk sharing; (2) achieving economies of scale; (3) gaining access to an important market segment; (4) penetrating an important foreign market (geographical access); (5) reducing funding risks and constraints; and (6) circumventing acquisition barriers. In the case of local credit unions, forming a joint venture to target the unbanked population would spread the costs and risks associated with developing the new product, it would also be conducive towards achieving economies of scale in the delivery of the new product, and would allow credit unions to tap a new and important market for them.
- **Explore Options for Collaboration with Commercial Banks** – Commercial banks face the same economic constraints that affect credit unions efforts to target the unbanked. In principle, there should be no obstacles to collaborating with commercial banks: the potential market is large enough, the costs and risks are high and the incentives for targeting the unbanked are the same for both groups. An interesting alternative could be the creation of a "virtual" joint venture between commercial banks and the credit union sector. A virtual joint venture is a joint venture created and governed solely through contracts between the parties and it is an increasingly popular alternative to the creation of a new venture through the use of a business entity which is jointly owned by the venturers. In the establishment of a virtual joint venture, the parties would enter into contracts which would link their activities in a particular line of business, a specific market segment or geographic location so that the risks and profits, if any, are shared as if they owned proportionate equity interests in a separate vehicle. In the case of local credit unions and commercial banks, the parties would enter into a contractual agreement to share all the overhead costs associated with product development and share all the profits

earned from the venture product. The formula for apportioning costs and earnings would be agreed to by all venture partners.

In summary, credit unions in Puerto Rico currently possess all the elements necessary—capital, operating experience, brand name, technology—to commence offering products targeted to the unbanked population. In our view, credit unions also have the potential to make substantial progress in targeting the unbanked because they :(1) are used to offering financial education and counseling, which help overcome barriers to access; (2) are open to collaborating with other credit unions in developing new products for the unbanked, which helps lower R&D costs; (3) have a presence in every town of the island, enjoy widespread membership and have access to state of the art technology, which allows for scale; and (4) are non-profit entities, which gives them more leeway in term of offering new products to the unbanked population.

We propose that credit unions offer three new products to reach the unbanked: (1) low-cost, low-fee beginner accounts; (2) stored value cards and (3) individual development accounts.

VI. Findings and Recommendations

A. Principal Findings

In this section we set forth the principal findings from the review of the existing literature and the original research and study we conducted in connection with this paper:

1. The Unbanked

a. A significant minority 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.

b. The Puerto Rican unbanked prefers to cash checks at financial institutions. A large majority (73%) of the unbanked did not have a credit relationship and only 8% reported savings of any sort.

c. Most unbanked households paid for their utilities bills in cash in person at a commercial office of the agency.

d. Eighty-five percent of the establishments that cashed checks for the unbanked in Puerto Rico provided this service without charging a fee. 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.

e. The number of unbanked 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.

f. Similarly, the high frequency of the use of financial institutions for cashing checks is indicative of relatively broad geographic accessibility. This 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.

g. In terms of the financial cost for accessing basic financial services, we have seen that those costs in Puerto Rico, while lower than in the United States, are still greater than zero. These check cashing fees are paid by families that had an average monthly income of $706, mostly for cashing checks issued by the government (the most important source of income for the unbanked in Puerto Rico).

h. A significant portion of these check cashing costs could be avoided, if recipients had bank accounts, by directly depositing government funds via EFT into their accounts. The government would also save money by using an electronic funds transfer system instead of checks to make payments.

i. The unbanked often lack access to any regular mechanism to save, which impedes the accumulation of savings, even if in a family that has the desire, the income and the will to defer consumption. This expected theoretical result is borne out in Puerto Rico, where only 8% of the unbanked population reported savings of some sort in 2002.

j. Another cost associated with being unbanked takes the form of reduced access to credit. Without a bank account it is extremely difficult to qualify for a loan or to establish a credit history. This pattern appears to be prevalent in Puerto Rico, where 73% of the unbanked did not have credit, at least not through formal providers.

k. Most of the unbanked in Puerto Rico pay their utilities and many other recurrent monthly expenses in person at the office of the company/agency they need to pay. This pattern of payment implies that thousands of man-hours every year are spent by the unbanked in Puerto Rico commuting from home to the commercial office/customer service office of these companies, standing in line, and commuting back after making the payment. This pattern may be repeated over and over every month for five or six different service providers. Although further research is needed on this issue, it appears to us that the opportunity costs associated with this behavior are high. If the customer is unemployed, she is wasting valuable time that could be put use in a training/education program or actually looking for work. If the person is employed part-time, she is misusing time that again could be used for training/education purposes. And if the person is employed full-time, this entails being absent from work for significant periods of time every month.

2. Asset Building

a. 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.

b. In general, asset accumulation could be expected to be associated with the following benefits:

- Improving household stability;
- Creating an orientation toward the future;
- Stimulating the development of other assets;
- Enabling focus and specialization;
- Providing a foundation for risk taking;

- Increasing personal efficacy;
- Increasing social influence;
- Increasing political participation; and
- Enhancing the welfare of offspring.

c. Asset building would represent a new approach to welfare policy in Puerto Rico. In general, welfare policy in Puerto Rico traditionally has focused on the issue of income distribution. If we employ the often used metaphor of a ladder, traditional welfare policy addresses the question of how far apart are the rungs in the ladder. The usual answer is to reduce the distance between the rungs by providing income supports for the poorest, while mostly ignoring the working poor. The failure of these policies has been stark. Today 44% of Puerto Rican families and 58% of their children live in poverty.

d. Asset accumulation, on the other hand, addresses issues of opportunity, that is, it focuses on the question of who occupies which rung of the ladder and the related issues of social mobility within and between generations. Unlike traditional approaches to social welfare, it seeks to provide all citizens not with a temporary palliative but with the means to genuinely take advantage of their talents and move up the ladder for good.

e. Spreading asset ownership will also serve as a powerful new engine of economic growth and employment, as generations of young Puerto Ricans invest in their education and start new business ventures. Of course, many will fail and still others will make foolish decisions with their assets. But many others will not. Over the long-term, this increase in entrepreneurial activity will pay off, with a net positive effect on economic and social life. In addition, as the private sector grows, there will be less pressure on government to provide employment to hundreds of thousands of Puerto Ricans.

f. Asset accumulation could be a powerful tool in changing the nature of the increasingly inflexible class structure that is emerging in Puerto Rico: a lower class destined to dead-end jobs and rampant unemployment, an upper class of professionals enjoying unprecedented prosperity, and an enormous middle class trapped in the swampy quagmire of economic stagnation. Social policy thinking in Puerto Rico has not caught up with this emerging reality. Asset accumulation can change this social dynamic by breaking the cycle in which inequality of outcomes in one generation becomes inequality of opportunity in the next.

3. Credit Unions

a. There is widespread variation in credit union size, assets, and number of members. Credit unions range in asset size from a low of $150,000 for the smallest credit union to assets of over $400,000,000 for the Arecibo credit union (COOPACA). In terms of number of members, credit union membership ranges from 46 members at the smallest credit union to over 79,000 at COOPACA.

b. Aggregate figures also conceal disparate trends in the concentration and distribution of assets and members among Puerto Rico credit unions. For example, the 20 largest credit unions in Puerto Rico, which constitute 15% of credit unions in operation as of March 31, 2004, hold 53% of total credit union assets, account for 51% of credit union members and employ 47%% of all credit union employees.

c. Therefore, the other 120 credit unions, which represent 85% of all credit unions, hold 47% of total assets, account for 49% of credit union members and employ 53% of all credit union employees. These disparities in the concentration of assets, members and employees, highlight the fragmentation that has traditionally characterized the cooperative sector in Puerto Rico.

d. During the last four years, credit unions have demonstrated substantial increases in total assets, loans and deposit activity, which is indicative of the relative strength of the sector. Furthermore, credit union membership, which stands at 854,223, or approximately 32% of the population older than 18 in Puerto Rico, is indicative of the attractiveness of credit unions to a large segment of Puerto Rican society. Even if we reduce the number of members by 25% to account for multiple memberships, approximately 24% of the adult population, or 1 person in every 4, is a member of a credit union in Puerto Rico.

e. More than half of the outstanding loans made by credit unions in Puerto Rico were personal loans, which are used mostly to finance personal consumption. Commercial banks, on the other hand, have financed mostly the acquisition of real property and the operations commercial and industrial concerns. In other words, commercial banks have concentrated on financing the acquisition of real assets, that is, they are financing investment, and the productive side of the Puerto Rican economy. While federally insured credit unions, in contrast with both local credit unions and commercial banks, have emphasized the vehicle financing and first mortgages, instead of financing consumption or on-going operations of industrial or commercial firms.

f. Credit unions are a small but significant part of the Puerto Rico financial system. In terms of personal financial assets, Puerto Ricans held $31.016 billion in financial assets as of the end of fiscal year 2002. Of that total, $18.592 billion, or 59.9%, were deposits held in commercial banks, $4.843 billion, or 16%, were deposits in credit unions, and $4.882 billion, or 16%, represented holdings in public pension funds.

g. Credit unions have invested only 1.8% of their assets in other cooperative enterprises in Puerto Rico, which is indicative of the eminently conservative nature of credit union management in Puerto Rico.

h. Through our research we have been able to identify some areas which present shared challenges to credit unions in Puerto Rico. Among these areas are capitalization, human resources, information technology, small business loans, bulging mortgage portfolios, threats to tax exemption, the regulatory role of COSSEC and the temptation to forsake their social mission in order to compete with banks.

i. In our opinion, credit unions' willingness to work and be flexible with clients, in addition to their positive image in the community, their social mission anchored in cooperative principles, their importance as cultural/social centers, their experience, albeit unstructured, in offering services to the unbanked, their relative financial strength, their geographic presence and the new legal powers granted credit unions by Act 255, make credit unions a good vehicle to target the unbanked population in Puerto Rico.

4. Banking the Unbanked in Puerto Rico

a. 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 difficulty lies in moving these consumers further along the credit path and encouraging them to become savers, then borrowers and finally, owners.

b. The challenge to reach the unbanked is to develop products with the following characteristics:

- 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.

c. Credit unions have the potential to make substantial progress in targeting the unbanked because they:

- Are used to offering financial education and counseling, which help overcome barriers to access;
- Are open to collaborating with other credit unions in developing new products for the unbanked, which helps lower R&D costs;
- Have a presence in every town of the island, enjoy widespread membership and have access to state of the art technology, which allows for scale; and
- Are non-profit entities, which gives them more leeway in term of offering new products to the unbanked population.

d. There are significant overhead costs for research, product development, training, marketing, and education associated with increasing financial access for the unbanked and expanding the offer of financial services to lower-income clients. These significant up-front costs are a problem for two reasons:

   - First, while a credit union's monthly recurring costs associated with administrating a low-cost account can be recovered by charging low monthly fees, recovering these overhead costs may result in fees that most unbanked households may be unwilling to pay.
   - Second, individual credit unions may be unwilling to undertake these up-front costs if the return, in the form of low-cost accounts, will be shared widely with other credit unions which did not undertake any significant costs for developing the new product.

e. These obstacles can be overcome through collaboration and cooperation among and between actors in the cooperative sector, as well as through cooperation with commercial banks. The credit unions are particularly well suited for this kind of arrangement because collaboration is intrinsic to their mission.

B. Recommendations to Credit Unions and Cooperative Institutions

1. Develop Basic "Beginner" Accounts

These would be electronic accounts, accessible through an on-line (real time) debit card. It would provide ATM access, at least between 3 to 5 free withdrawals per month. It would also provide access to a POS network. No minimum balance requirement, but credit unions should be able to charge a monthly fee lower than the fee applicable to traditional paper-based checking accounts. Check deposits would be cleared immediately. This account should allow for additional deposits and have a basic bill payment feature. It may also include, at the customer's option, a structured savings mechanism that automatically sweeps at least $10 per month for the purchase of common shares in the credit union.

2. Stored Value Cards (SVCs)

Credit unions may offer open loop, re-loadable stored value cards, which provide clients with the ability to utilize their cards for multiple purposes and at multiple points of sale. Credit unions may contract with a non-bank vendor to operate the cards issued by local credit unions. It would provide ATM access, at least between 3 to 5 free withdrawals per month. It would also provide access to POS network. Re-loads would be available at the credit union. Fee structure needs to be worked-out. In the U.S. some SVC providers offer consumers the ability to build a credit history by reporting to credit bureaus. Similar feature should be considered in Puerto Rico. It may also include, at the customer's option, a structured savings mechanism that automatically sweeps at least $10 per month for the purchase of common shares in the credit union.

3. Credit Union Individual Development Accounts (IDAs)

Account holders will be required to save a minimum of $10 a week. Credit unions may offer matches up to $1,040 per year, either in cash or shares. Another distinguishing characteristic of IDAs is that participation is conditioned upon the saver's completion of a financial education program. Credit unions, as part of their social mission, would design and offer this financial education component. Finally, IDA withdrawals will be limited to specific purposes. The main objective of IDAs is to help families with little or no assets to build human and financial capital. Thus, the typical IDA program allows only three uses for the savings: (1) downpayment on a house, (2) getting an education, or (3) starting a small business. Credit union IDAs would be restricted for similar purposes.

An IDA which included matching deposits in the form of credit union shares, would help account holders to move along the credit path by creating a link between savings and credit products given that many credit unions in Puerto Rico are willing to lend against the value of their own shares in a ratio of four to one.

At the end of three year IDA period, if the account holder has deposited the maximum amount, she would have over $3,000 worth of credit union shares which she could leverage to obtain a personal loan in excess of $12,000. In terms of the credit path, our hypothetical client would have moved from saver to borrower in one step.

4. Provide Free Tax Preparation in Exchange for Opening a Savings Account

Credit unions should also consider providing free tax preparation services to clients or potential clients who (i) expect to receive a refund from Hacienda and/or (ii) qualify for the refundable federal Child Tax Credit. In exchange for this service, individuals would agree to open a basic savings account at the credit union with a specified percentage of the refund and/or credit they receive.

5. Create and Endow the Puerto Rico Center for Financial Access Research and Innovation

This non-profit research institution could be funded by credit unions, the Banco Cooperativo and perhaps commercial banks. The Center would: execute market and marketing research, carry out new product development, provide training to credit union employees, develop a financial education curriculum for Puerto Ricans, offer financial education seminars and workshops, and develop a Puerto Rico-based credit evaluation methodology and software, which could be used to collect data regarding rental, utility, insurance, student loan and other bill payments to help credit unions conduct a credit analysis of persons who otherwise do not have a credit history.

6. Revitalize the Instituto de Cooperativismo

The Instituto de Cooperativismo at the Universidad de Puerto Rico could be a valuable contributor to the development of the credit union sector in Puerto Rico. Fomento

Cooperativo, la Liga de Cooperativas, Banco Cooperativo and the credit unions, working together with the management of the Instituto and other UPR resources, should develop a strategic plan for the Instituto. Such a plan should include a thorough assessment of the strengths, weaknesses, opportunities and threats affecting the Instituto, a new vision for the Instituto, and a specific plan for achieving that vision. It should also include a survey of potential financing sources from outside the UPR structure. The Instituto should also consider offering joint courses with UPR school of law and the graduate school of business, and specifically, the development of curricular requirements to confer a certificate in Cooperative Management to MBA students who satisfy such requirements.

7. Financial Education

Any effort to reach the unbanked and to encourage asset building would be incomplete without a strong financial education component. Financial education is essentially a public good in the sense that its benefits will be enjoyed by all financial institutions, regardless of which bear the actual costs of providing such education. The cooperative sector, in conjunction with the Department of Education and private sector entities, should take the lead in developing a comprehensive K-12 financial education curriculum for Puerto Rico.

8. COSSEC Should Issue Rules and Regulations under Act 255

Act 255 grants broad regulatory powers to COSSEC. The extent to which credit unions will be able to use Act 255 to expand and grow their business will depend on how COSSEC uses these broad powers. Rules and regulations should be issued as soon as possible in order to minimize ambiguity and uncertainty in the reach, scope and interpretation of Act 255.

C. Recommendations to Government

1. Implement Laws and Regulations which Require Electronic Payment of Government Wages and Salaries, Retirement Benefits, Programmatic Benefits, and Consider Legislation to Require the Same for Vendor Payments and Expense Reimbursements to Businesses

Electronic payment of wages and salaries would provide an incentive for thousands of Puerto Ricans to come into contact with the mainstream financial system. Switching to electronic payments would also generate cost savings for the government as electronic transactions are considerably cheaper than processing paper-based transactions. In addition, electronic payment would reduce costs associated with lost or damaged checks, forgeries, counterfeiting and check alteration.

2. 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.

3. Provide Subsidy to Commercial Banks that Offer Beginner Bank Accounts

In order to induce commercial banks 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 banks 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.

4. 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.

5. Consider Tax Credit for Financial Institutions that Match IDA Deposits

Today, institutions in more than 40 states and Puerto Rico offer IDAs of some type. However, finding institutions to provide funds for the matching deposits has proven to be a challenge. In fact, many participants in a national IDA conference in New Orleans last year indicated that the unwillingness of financial institutions to match savings is one of the obstacles to offering IDAs in a massive scale. From a financial institution point of view, this makes sense (at least in the short term) because banks are not in the business of giving money away for free. Establishing a tax credit would provide strong incentives for financial institutions to market and sell IDAs.

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. The proposal is to reimburse financial institutions for matching funds they provide to qualified persons saving in an IDA. The credit could be designed to phase-in after a certain number of IDAs have been established (say 50 or 75 accounts) at the financial institution and to increase gradually with the number of accounts until it reaches a cap.

6. 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.

7. *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.

8. Consider Offering Tax Exemption for Interest and Capital Gains Generated by Derivative Financial Instruments based on Mortgages Underwritten by Credit Unions

Currently, most credit unions have to hold on to their mortgage loans until the maturity due to the lack of a liquid secondary market. The government could encourage the securitization of credit union mortgages by exempting credit union mortgage-backed securities from local taxation. The Banco Cooperativo could act as pooling and securitization agent on-behalf of credit unions.

D. Areas for Additional Research

In the course of our research for this paper we have identified other areas which deserve further study. We note the following among the most important:

1. Capitalization Alternatives for Credit Unions – Act 255 requires that all credit unions satisfy certain statutory requirements for capital at risk. Some of our interviewees expressed concerns regarding the capability of all credit unions to meet these targets. In order to avoid potentially costly bailouts or disruptive mergers, the credit unions need to undertake an in depth study of alternatives to increase capitalization to statutory levels.

2. Staff Education and Training – If credit unions are going to offer new products, such as commercial loans, then they will have to undertake a thorough assessment of their human resources in terms of education, experience and sophistication. The commercial loan market is highly competitive in Puerto Rico and tapping this market, as well as managing the risks involved, requires top notch personnel. A comprehensive study of personnel needs should be undertaken as soon as possible.

3. IT Systems – Information technology to manage information flows is extremely important in the financial services industry. Client interfaces, risk management and internal controls and back-office operations all require substantial investment in information technology. We found wide disparities in credit unions' information technology systems. The industry, perhaps under the leadership of Banco Cooperativo, should undertake a survey of IT deficiencies, develop a plan to address those needs and set industry wide standards for IT systems in credit unions.

4. Development of Secondary Market for Credit Union Mortgages – We have already mentioned the problem regarding the secondary market for credit union mortgages. Possible alternatives include securitization (described above), the creation of investment companies that purchase mortgage pools from credit unions with the proceeds common stock issued to the public, and/or some sort of guarantee by the Banco Cooperativo or GDB. These alternatives should be studied and considered in the context of the experience of the commercial mortgage banking industry in Puerto Rico.

5. Restructuring of Cooperative Sector to Emphasize Financing of Local Enterprises

In Puerto Rico credit unions, which provide mostly personal loans, are more numerous than production oriented cooperatives. Credit union capital, therefore, has not, by and large, been used for the financing of local enterprises. A comparative study of the experience in other countries, such as Costa Rica and Spain, should be undertaken in order to develop recommendations for the efficient use of credit unions assets to finance significant economic activity in Puerto Rico.

E. 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."[70] Financial access is also crucial to realize the potential of asset-building policies.

We believe that credit unions can contribute greatly to improve financial access in Puerto Rico. Credit unions, because of their cooperative nature, are used to collaborating on complex projects. In addition, many credit unions already offer financial education and counseling, which help overcome barriers to access, are willing to cooperate with other credit unions in developing new products for the unbanked, which helps lower research and development costs, have a strong geographic presence and enjoy widespread membership, which allows for scale, and are non-profit entities, which gives them financial flexibility when evaluating the costs of offering new products to the unbanked population. What is missing is the institutional leadership to focus these elements to reach the unbanked.

With strong leadership and cooperation, credit unions can make a significant contribution to helping Puerto Ricans make the most of life's chances. Credit unions, 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. The implementation of the recommendations set forth in this paper can, in short, help bring about a nation of owners. It is up to each of us to do our part to make it a reality.

[70] 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.

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