Trends and Future Directions in Consumer Financial Services: A Colloquium at Rochester Institute of Technology

filene
RESEARCH INSTITUTE

Trends and Future Directions in Consumer Financial Services: A Colloquium at Rochester Institute of Technology

filene
RESEARCH INSTITUTE

ISBN 978-1-932795-59-2
Printed in U.S.A.

Progress is the constant replacing of the best there is with something still better!

— *Edward A. Filene*

Deeply embedded in the credit union tradition is an ongoing search for better ways to understand and serve credit union members. Open inquiry, the free flow of ideas, and debate are essential parts of the true democratic process.

The Filene Research Institute is a 501(c)(3) not-for-profit research organization dedicated to scientific and thoughtful analysis about issues affecting the future of consumer finance. Through independent research and innovation programs the Institute examines issues vital to the future of credit unions.

Ideas grow through thoughtful and scientific analysis of top-priority consumer, public policy, and credit union competitive issues. Researchers are given considerable latitude in their exploration and studies of these high-priority issues.

The Institute is governed by an Administrative Board made up of the credit union industry's top leaders. Research topics and priorities are set by the Research Council, a select group of credit union CEOs, and the Filene Research Fellows, a blue ribbon panel of academic experts. Innovation programs are developed in part by Filene i^3, an assembly of credit union executives screened for entrepreneurial competencies.

The name of the Institute honors Edward A. Filene, the "father of the U.S. credit union movement." Filene was an innovative leader who relied on insightful research and analysis when encouraging credit union development.

Since its founding in 1989, the Institute has worked with over one hundred academic institutions and published hundreds of research studies. The entire research library is available online at www.filene.org.

Acknowledgments

The Filene Research Institute would like to thank Professor Bob Manning from Rochester Institute for Technology (RIT) for hosting and contributing to this colloquium. We would also like to thank our esteemed panel of experts: Danny Schechter, Globalvision; Bill Hampel, CUNA; Kathleen Keest, Center for Responsible Lending; Stephen LaGrou, RIT; Lois Kitsch, National Credit Union Foundation; Max Wolff, New School University; and Cindy T. Cooper, City of Buffalo. We are indebted to Bob Jacobson for his considerable creative contributions to this report. Finally, special thanks go to Molly Weimer and Tom Upchurch of Responsible Debt Relief and Josey Siegenthaler and Kelsey Balcaitis at Filene for their ability to simply get things done.

Table of Contents

Executive Summary and Commentary

By George A. Hofheimer,
Chief Research Officer

To be uncertain is to be uncomfortable, but
to be certain is to be ridiculous.
—Chinese Proverb

My job, analyzing and researching the future of consumer finance, gives me the potential to look ridiculous from time to time. To hedge against the "looking ridiculous" factor, I work closely with tremendously gifted academics who realize uncertainty is a way of life, not an exception. This skill took on a tremendous amount of importance in the report you are about to read.

In 2006, Bob Manning, a professor of consumer finance at Rochester Institute of Technology (RIT), proposed a research project examining the entry strategies of Wal-Mart into the U.S. financial system. As part of the project, Filene held a colloquium at RIT in late 2008 to discuss the implications of a Wal-Mart entry scenario for credit unions. As planning began in early 2008 for this colloquium, some funny things began happening that portended the environment credit unions now find themselves in. Never one to waste a crisis, Manning proposed to widen the scope of our inquiry at the colloquium from just Wal-Mart to address the huge, stinky, hairy, shrieking elephant in the room, and that elephant was the new (and forthcoming) reality for consumer financial services.

This change of direction caused me mild discomfort since it seemed in the parlance of project management "out of scope." However, as the banking world imploded throughout 2008, this broader scope sounded less and less ridiculous. In short, the Wal-Mart question became less critical as the economy, spurred on by huge bank failures, teetered on the edge. A famous quote from the infamous George S. Patton kept creeping into my brain as we planned for this broader agenda, "A good plan violently executed now is better than a perfect plan executed next week." While I don't think you can rightly describe an academic colloquium as "violently executed," the topics, presenters, and goals represent a good, albeit imperfect, list of topics. Dramatic changes in the world of finance and politics caused our agenda to shift up until the very moment we opened the colloquium in late November 2008 in snowy Rochester, New York.

What follows is a summary of the "Trends and Future Directions in Consumer Financial Services" colloquium, held at RIT's Saunders School of Business. In its final iteration, the colloquium examined the impending changes to the retail banking sector brought on by the subprime lending crisis, the arrival of a new political reality in Washington, DC, and the current economic environment. The report focuses on three key areas:

1. **How we got here.** This section examines regulatory, consumer behavior, and banking practices that landed us in our current economic predicament.
2. **Wal-Mart as a financial services provider.** Not wanting to ignore an important competitive question, this section weighs in on the likelihood of Wal-Mart's entry into the U.S. financial services marketplace. We rightly frame this question in the realities of today's marketplace.
3. **A new banking reality?** Given where we are today and where we are going, this section lays out the potential regulatory, competitive, and consumer demands of a new banking paradigm.

The goal of a colloquium is to hear a variety of viewpoints and proposals. As you read through this report, you will likely conclude that we more than achieved this goal; however, the audience, the presenters, and the observers did come to one clear and unequivocal consensus: Tomorrow's financial services world will look monumentally different from today's. While the ancient Chinese proverb noted above implores us to be comfortable with ambiguity and eschew certainty less we look ridiculous, in this circumstance we can feel comfortable knowing that the only certainty is that tomorrow will look materially different from today. This report should be helpful in guiding your credit union through these difficult times.

CHAPTER 1
How We Got Here

Understanding what led to our current financial crisis can help us develop coherent strategies for navigating these uncertain times. Deregulation, the "double bubble," risky securitization, and expanding consumer debt have all played a part in the backstory of this crisis.

The economy is a complicated beast; it would be foolish to attempt to explain in a single short publication all the complex, interrelated events, cycles, actions, inactions, and accidents that have landed us where we are today. However, armed with a bit of hindsight, it is not that difficult to trace a significant share of today's financial turmoil to a handful of understandable phenomena we have experienced over the last several years. Only by understanding, at least to some degree, the story that led to our current financial crisis is it possible to develop coherent strategies for steering the narrative toward a happy ending. It is a compelling story so far, populated by a colorful cast of characters familiar to any drama fan—irresponsible officials, duped innocents, greedy overlords, and more. Following is a superficial, but accurate, summary of some of the story's key plot points.

COLLOQUIUM COLLABORATORS

This section draws on the presentations by Bob Manning, Max Wolff, and Danny Schecter.

Bob Manning is research professor and director of the Center for Consumer Financial Services, and past Caroline Werner Gannett Chair of the Humanities at RIT. He is a Filene Research Fellow and the author of the award-winning book *Credit Card Nation: America's Dangerous Addiction to Credit* (Basic Books, 2000).

Max Wolff is an economist and freelance writer/researcher. His work appears regularly in the *Asia Times,* the *Prudent Bear,* and many other international publications. Much of his research focuses on international financial risks and opportunities.

Danny Schechter is a television producer and independent filmmaker who also writes and speaks about media issues. He is executive editor of MediaChannel, a major online source of information and analysis on media issues. His television and film production company, GlobalVision, has produced hundreds of pieces on human rights, economic justice, political malfeasance, and other important issues.

Deregulation

A large part of the story of how we got here has to do with the deregulation of the financial industry. Over the decades, the system has changed from risk-averse, community-based banks interested in local development to a much more freewheeling global banking system more interested in managing risk by dumping it on somebody else, constrained only by the limits of its own creativity in concocting new ways to exchange packages of debt. Mention the word "deregulation" in the context of financial services, and most people immediately think of what took place during the Reagan administration, starting with the Depository Institution Deregulation and Monetary Control Act of 1980. This law did many things, including phasing out the Regulation Q ceilings on interest rates on deposits, which had been in place since passage of the Glass-Steagall Act of 1933. It also explicitly allowed credit unions to offer a host of new products, such as share draft accounts and IRAs. That round of deregulation is often cited as one of the contributing factors to the Savings and Loan crisis that took place later in the decade.

But some of the acts of deregulation that have had the greatest impact in shaping the current financial landscape took place both before and after the Reagan years. In 1978, the U.S. Supreme Court ruled in Marquette v. First Omaha Services that banks only have to follow the interest rate limits in the state they're based in—not those of the states where their customers live. This ruling, as Manning put it, "allowed banks to essentially usurp the federal usury law." So in effect, there was no longer an interest rate cap on most types of lending, including credit cards. And indeed, shortly after the Marquette ruling, Citibank moved to South Dakota, which had done away with its usury laws.

Fast forward to the Clinton years, and we see an economy "on steroids," with consumers spending more than they were earning. Income inequality grew with wages at the bottom and middle of the distribution losing ground to inflation. By the mid-1990s, American consumers were interested in borrowing more and more, rolling over financing with more and more total debt. But there was not sufficient domestic savings to sustain all of this debt. So where did the money come from? It came from overseas, made possible by global financial deregulation and the rise of the international bank. This economic priming accelerated in 1998, with the Asian financial crisis and the breaking open of the last great untapped reserve of savings in the world, East Asia. These events allowed the American credit bubble to get much bigger.

More recently, another regulatory issue has come into play that could reshape the financial services landscape. The entry of Wal-Mart into the U.S. financial services business—a process closely tied to the evolution of regulations governing who is allowed to offer which kinds of financial services—gives rise to a host of questions addressed later in this publication. Given the sheer size of its customer base, the array of services Wal-Mart is ultimately allowed by regulators to offer could play a significant role in how Americans borrow and save in the years to come.

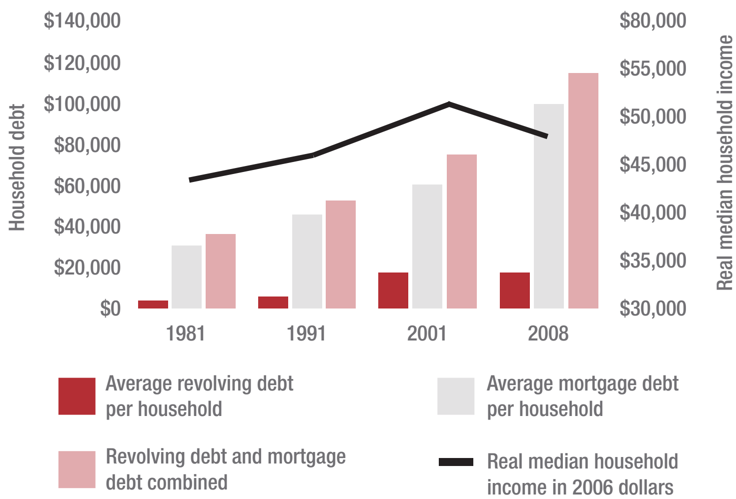
The financial chaos of the recent months has effectively spelled the end of the deregulation era. With the arrival of a new administration in Washington, strong majorities for the Democrats in both houses of Congress, and the disgust of the American public—disgust they expressed forcefully on election day—there is no question that financial services are headed for a period of significant re-regulation. The only questions are the degree and form that re-regulation will take.

> In 2001 I wrote an article after the NASDAQ global collapsed, and I referred to the U.S. economy as an athlete on steroids. With the easy credit that was emerging in 2001, it was very clear that Chairman Greenspan had made it a centerpiece of the economic recovery in the weak 2001 recession that the U.S. would be propelling itself not on rising income . . . but on easy access to credit, and ultimately wealth-based extraction of home equity.
>
> The real question that I raised was not the financial steroids themselves and those implications, but what was going to happen when the steroids wore off. And that's really where we are today. And what is astounding is so few analysts really asked that question, of what the impact was going to have in terms of the easy credit impact.
>
> —*Bob Manning (presentation at colloquium)*

The Double Bubble

The relaxation of regulatory oversight allowed a number of things to happen to the economy both nationally and internationally. With regard to how deregulation created the landscape in which the current recession took hold, Manning has written and spoken extensively about a "double financial bubble," which fundamentally distinguishes this recession from other recent ones. The first bubble, which has captured the lion's share of attention, is the housing bubble that began to burst with the collapse of the subprime mortgage market. The other bubble, which has been largely ignored by the media, is the explosive growth in the debt load carried by American consumers. Lurking beneath the double bubble is the rarely reported fact of declining incomes among all but the highest portion of the American income distribution. That's what really sets this recession apart from the others that took place over the last few decades. During those recessions, consumers took on a lot of debt, but household incomes continued to grow. This time around, along

Figure 1: Average Household Debt vs. Median Household Income in Current and Past Recessions



Source: Bob Manning, "In Debt We Trust: The Subprime Lending Crisis, the Consumer-Led Recession, and the Imperative of 'Responsible Debt Relief'" (presentation, Rochester Institute of Technology, Rochester, New York, November 2008).

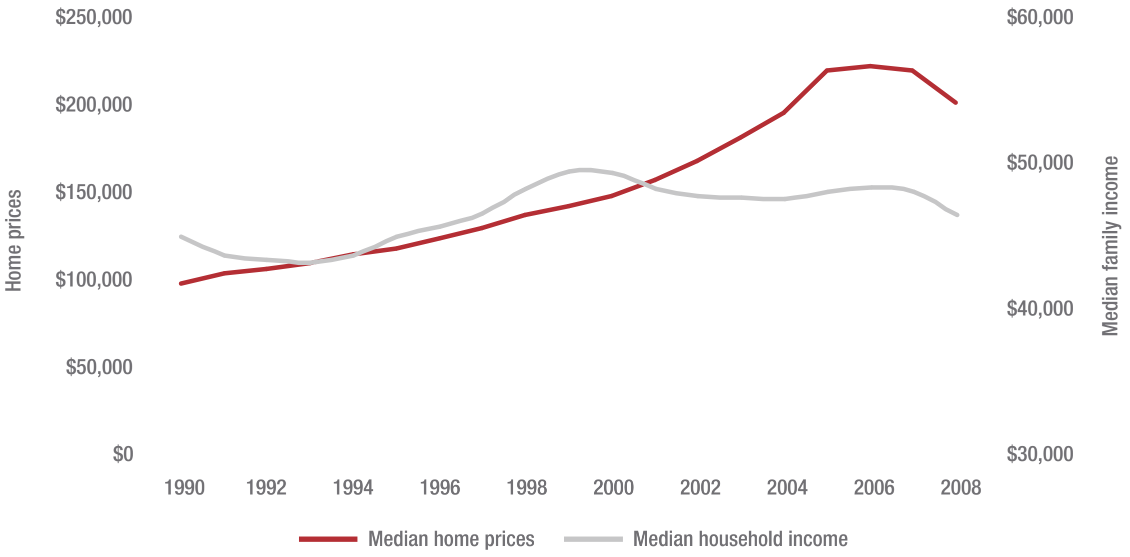
COMMENTS FROM REP. DENNIS KUCINICH: A PUBLIC POLICY PERSPECTIVE

Rep. Dennis Kucinich (D-Ohio) has represented Cleveland's 10th District in Congress since 1996. During his time in Congress, Rep. Kucinich has been one of the House's most progressive members. Throughout his career, both in Congress and before, he has been an outspoken champion of human rights, workers' rights, and social and economic justice. As of November 2008, Kucinich had held six hearings on the housing and subprime mortgage crisis as chair of the Subcommittee on Domestic Policy and the Committee on Oversight and Governmental Reform. In his remote video presentation to the colloquium, he noted that American homeowners have already lost $5 trillion (T) in housing wealth, with that figure certain to grow before the housing market finds its floor. Kucinich is fighting to ensure that a reasonable share of federal bailout dollars is directed toward assisting homeowners, not just bank shareholders. He advocates a plan of action to stabilize the economy that includes a major campaign to modify mortgages in danger of default; assistance to the auto industry to protect as many good-paying jobs as possible; a massive public works program focused on the nation's infrastructure; and a complete overhaul of the way health care is administered and financed, through creation of a national not-for-profit system akin to Medicare. Kucinich believes that Americans clearly expressed a desire for these sorts of reforms with their votes in the November 2008 election, and that beginning in 2009 the climate in Washington will be more conducive to such change than it has been in decades.

with unprecedented levels of consumer debt, we're seeing a decline in real household income.

Between 2001 and 2006, U.S. home prices grew at a rapid clip. Meanwhile, consumers had easy access to credit. And even though incomes were stagnating, the economy "felt" good to consumers; they were able to purchase a lot of goods and services on their credit cards, racking up record amounts of debt. And because their homes were appreciating so much so fast, they knew they could tap into their home equity whenever their credit card debt got a little out of hand. Easy credit came in a variety of forms. In addition to credit cards, homebuyers were able to get huge mortgage loans that took a number of new forms, including adjustable rate mortgages (ARMs), interest-only, etc., often without having to demonstrate an ability to pay based on their income. So people whose incomes were not growing were taking out gigantic loans to buy overpriced houses and filling them with furniture and appliances purchased on credit cards, with the expectation that their homes would increase enough in value to make their galloping credit card debt irrelevant. When they didn't have enough cash on hand to pay the credit card bill, they simply took out a home equity loan. This became an attractive option beginning in the late 1980s, when the interest on home equity loans became tax deductible. At the same time, underwriting standards were becoming weaker. Loans were no longer based just on income, but on a combination of income and some hypothetical estimate of

Figure 2: Median Home Sale Price vs. Median Family Income



The 2008 data point reflects the average of January and February monthly figures.

Source: National Association of Realtors, Real Estate Outlook, Market Trends & Insights; available at www.realtor.org/Research.nsf/files/EHSreport.pdf/$FILE/EHSreport.pdf. Real family income data from U.S. Census Bureau; available at www.census.gov/hhes/www/income/histinc/inchhtoc.html#6.

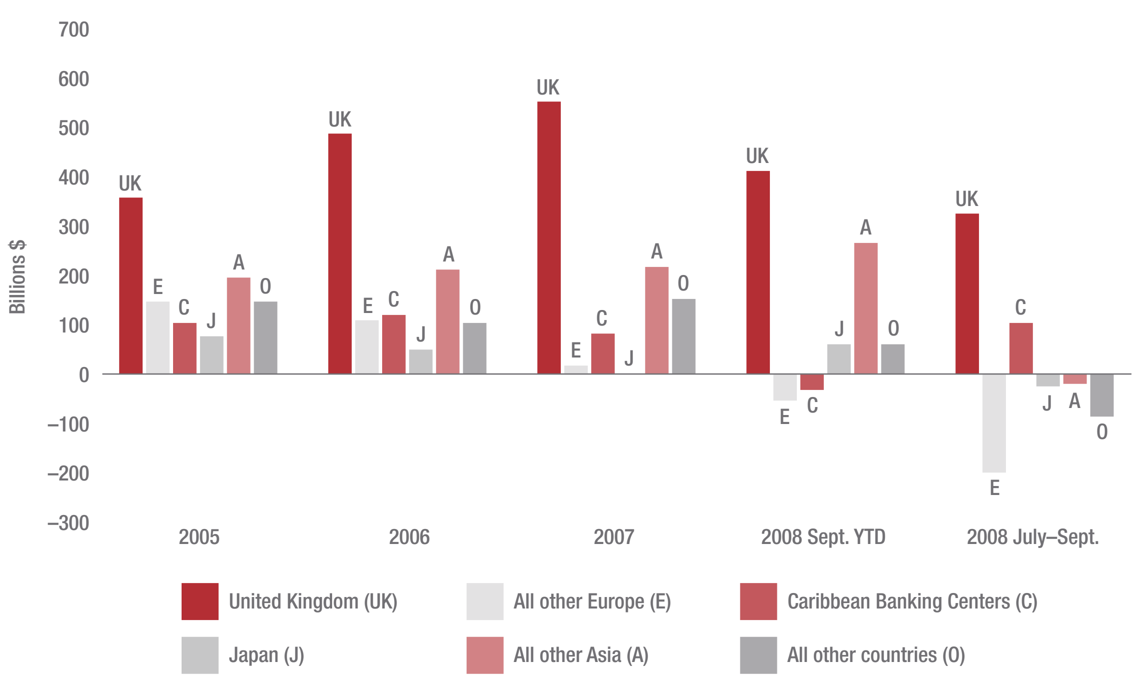
asset value. The result was banking practices that encouraged people to take on far more debt than they could afford to repay.

Securitization

While all of this personal debt was being accumulated, Wall Street and its international counterparts were trading briskly in securities backed by dubious mortgages and other consumer debts. These assets were sliced and diced and packaged in incredibly complex ways, masking the degree of risk investors were taking on. Why was Wall Street so reckless in its trading of these convoluted instruments? The answer is simple: Until the house of cards collapsed, they were highly profitable. In a sense it was a game of chicken. Nobody could afford to walk away from this lucrative market while competitors were still reaping enormous gains from it.

> If we're borrowing tons of money but we're also not saving much money, you should begin to scratch your head and say, "Gee whiz. Well, where does the money come from?" Where the money comes from is two large sources in the international community [United Kingdom and China] and then a large domestic source.
>
> —*Max Wolff (presentation at colloquium)*

Figure 3: Net Purchases of Long-Term Domestic Securities by Foreigners, Selected Countries



Source: Max Wolff, presentation at colloquium (Rochester Institute of Technology, Rochester, New York, November 2008).

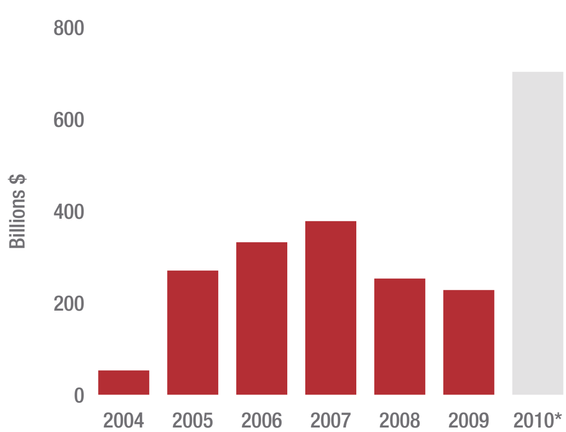
This phenomenon of securitization went beyond mortgages and beyond U.S. borders. Max Wolff pointed out that the United States outspent its own assets years ago, and that to cover its collective borrowing it went global, packaging American consumer debt and selling it in the international financial marketplace. Securitization is most commonly associated with mortgages, but credit card debt and other forms of debt are securitized as well, as banks seek to get these receivables off their books in order to accumulate additional capital to lend. All sorts of innovative products, derivatives, debt swaps, and the like were dreamed up to accomplish this, but what it amounted to was, according to Wolff, "taking what banks are doing and figuring out a way to chop it up, standardize it, and sell it to the global community. . . . The hot dog analogy springs to mind: chop up, reprocess it, and sell it." No matter that the final reprocessed product contained some rather unsavory parts of the pig.

The current subprime crisis amounted to, according to Wolff, "taking what banks are doing and figuring out a way to chop it up, standardize it, and sell it to the global community. . . . The hot dog analogy springs to mind: chop up, reprocess it, and sell it." No matter that the final reprocessed product contained some rather unsavory parts of the pig.

The problem with all this chopping and repackaging was that—to strain the metaphor just a bit further—there was not much meat in the mix. As the U.S. housing market cooled, economic growth slowed, and foreclosures and delinquencies began to proliferate, the value of these mortgage-backed securities deteriorated. The subprime market melted down, helping set into motion the sequence of financial catastrophes that followed.

As the subprime market capsized and sank, it took the rest of the housing market down with it. The residential foreclosure rate is at unprecedented levels, about triple the historic rate of 1%. Some four million households are behind on their mortgage payments. Nearly two million homes have already been foreclosed during the current cycle. Here's a sobering fact: Another large wave of subprime ARMs is scheduled to reset over the next couple of years, and $700 billion (B) worth of mortgages is expected to reset in 2010 and beyond (see Figure 4). A large percentage of these loans are at risk of default as homeowners face higher mortgage payments after the resets. The recent bailout bill passed by Congress is helping address Wall Street's

Figure 4: ARM Resets: First Mortgages Originated in 2004–2006



* 2010 and beyond

Source: Christopher L. Cagan, "Mortgage Payment Reset: The Issue and the Impact," First American Corelogic, Inc., March 19, 2007, www.facorelogic.com/newsroom/marketstudies/mortgage-payment-reset-issue-and-the-impact.jsp.

financial problems, but it does not provide direct assistance to homeowners being squeezed by their mortgage payments.

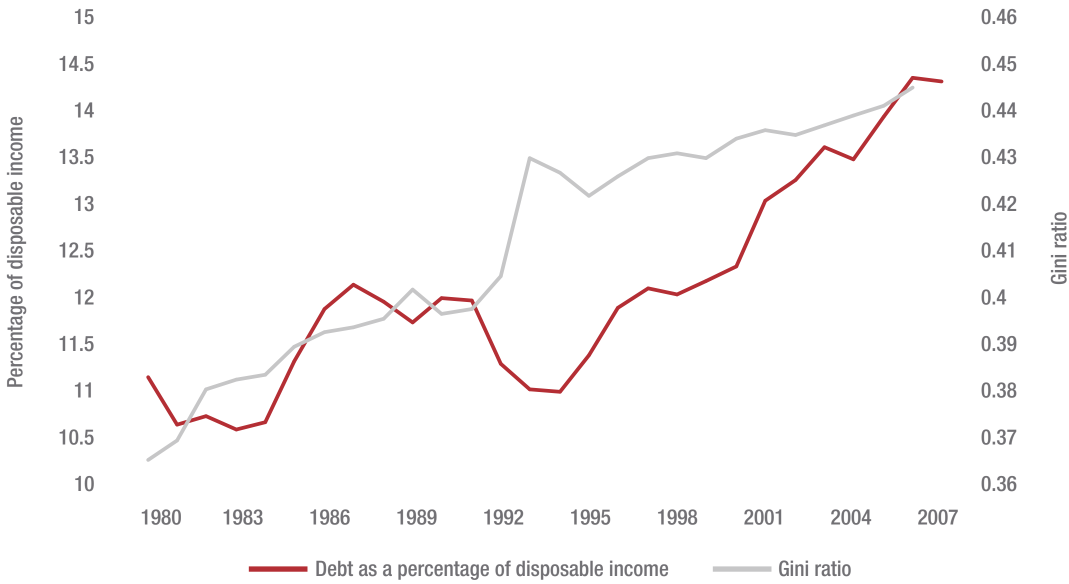
Consumer Debt

The second bubble, as has already been mentioned, is the explosive growth of consumer debt. It was easy for journalists and others to ignore the credit card bubble. After all, this bubble represents only about $800B in receivables, compared to a $10T mortgage market. But that $800B figure fails to capture the fact that the credit card business has long been a major profit generator for banks, capable of subsidizing other portions of their operation that were losing money. So the bursting of the credit card bubble, coming in the wake of the housing bubble's earlier burst, left major banks without any revenue-generating sector. Manning points out that this is essentially the first financial crisis the credit card industry has experienced since 1981–1982, which was really the beginning of the modern credit card era.

How did this second bubble inflate so much? One explanation seems to be a growing disconnect between incomes and consumer confidence between 2001 and 2006. Most people are making less money than they were in 2000. According to U.S. Census Bureau data, median real income has declined by $324 since that time. The picture is much worse for people in the workforce, and in particular for people with average or below-average incomes. Their incomes have dropped significantly, while those at the upper end of the income distribution have seen some gains. As income inequality worsened and real wages for most households declined, people continued to buy a lot of stuff because they believed the economy was strong. After all, unemployment was low, home values were high, and the stock market was thriving. While they were not bringing home any more money than before, they had access to easy credit. This access came in the form of both credit cards, which were marketed ever more aggressively and advertised as the key to an enjoyable lifestyle, and home equity, a seemingly endless fountain of credit that grew every year as home values escalated. So essentially, people replaced their declining wages with consumer debt. You can see the impact of this disconnect in Figure 5, comparing the Gini ratio, which measures income inequality,[1] with the growth of consumer debt in America. The graph shows a one- to two-year lag between the worsening of income equality and the point at which consumer debt begins to soar, in 1994.

While the fastest growth in consumer debt is in mortgages, it did not originate in the mortgages themselves; it's mortgage debt supersized by all the consumer debt that has been consolidated into it.

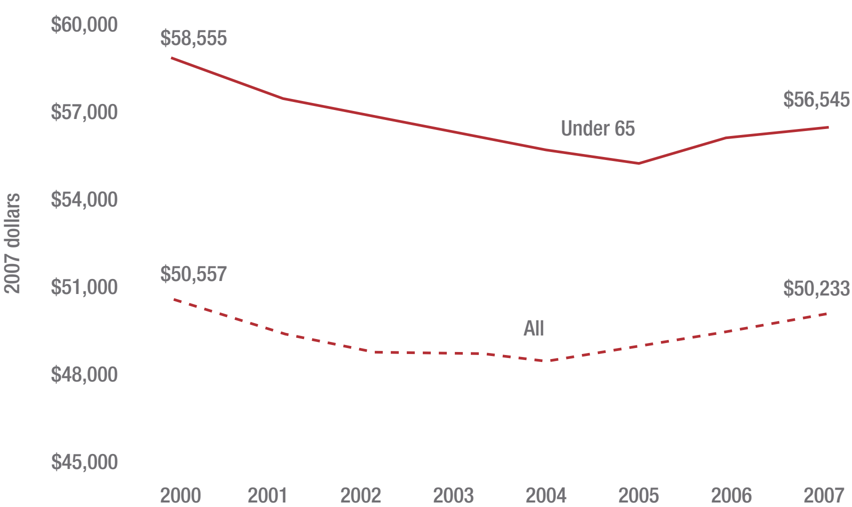
Figure 5: Consumer Debt Percentage Compared with Gini Ratio, 1980–2007



Debt payments consist of the estimated required payments on outstanding mortgage and consumer debt.

Source: Board of Governors of the Federal Reserve System, "Household Debt Service and Financial Obligations Ratios," www.federalreserve.gov/releases/housedebt/default.htm. Gini Ratios: U.S. Census Bureau, "Historical Income Tables—Income Inequality," www.census.gov/hhes/www/income/histinc/ie1.htm.

Figure 6: Real Median Household Income, 2000–2007



Aggregate revolving debt totaled $966B in the second quarter of 2008—20% percent higher when compared with 2003—according to the Federal Reserve Bank. Delinquencies on credit card accounts have risen to nearly 5%. Charge-offs have climbed to 5.62% in the third quarter of 2008, up from 3.87% in the third quarter of 2006.

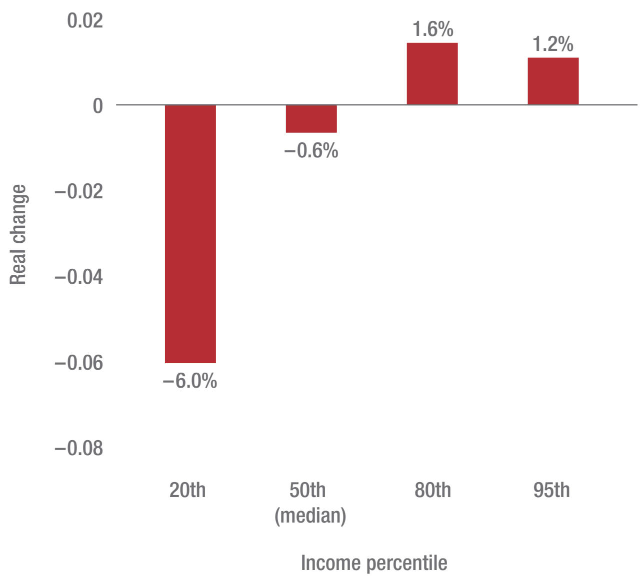
The two bubbles are integrally related. When housing prices were climbing rapidly from 2001 to 2006, credit cards were marketed very aggressively. The assumption was that while credit cards had

DANNY SCHECHTER ON THE MEDIA'S ROLE IN CREATING AND SOLVING ECONOMIC CRISES

During the 2008 presidential campaign, Republican candidate John McCain took a lot of heat for proclaiming that the fundamentals of the economy were sound at a time when the economy was, in fact, on the brink of major upheaval. But McCain was certainly not alone in whistling that tune. For the most part, the media stood by for months while evidence mounted that something had gone awry at the very foundation of the U.S. economy. Journalist and documentary filmmaker Danny Schechter has written extensively on the mainstream media's failure to report on the financial practices that contributed to the recession, and their general unwillingness to thoroughly explore the impact that the housing and consumer credit crises have had on working families. Schechter notes that his reporting on credit and debt issues, along with reports from a handful of others, was met with rolling eyes and mumbling about "alarmism" as recently as 2006, when the looming economic meltdown should have been visible to anybody paying attention. The exception was the occasional shrieking commentator, whose very media persona is based on extreme forecasts of impending economic doom. As Schechter put it: "So there has been this schizophrenia in the media. On the one hand a desire to keep consumer confidence up, to boost their advertisers, to give people the sense that all is okay. Then flipping the next moment into the darkest forecast of imminent, apocalyptic Armageddon." Consumers can therefore convince themselves that it is safe to keep on buying things on credit even as their income stagnates or shrinks, and write off the naysayers as depressed lunatics. Throughout the process, there is rarely a willingness to examine the malicious acts of greed that contributed to the situation. At the same time, lenders were spending billions of dollars advertising credit cards and home equity loans to people whose incomes were losing ground to inflation. Schechter calls on credit unions and the public to make a concerted effort to harness the power of the media to raise awareness about economic issues. Armed with information, concerned individuals and organizations can help direct the necessary resources toward communities that are hurting and families who are suffering, and stoke the kind of economic development that will lift America out of recession from the bottom up.

unsecured interest rates, they were actually secured by the asset value of homes. This was not an unreasonable assumption; after all, a lot of people were regularly extracting home equity to pay their credit card bills. Judging by media coverage of the economy during that period, one would assume that on the strength of increasing home values, most Americans were becoming much wealthier. But this was not the case. It was not a period of wealth accumulation for the American middle class; it was a period of debt accumulation.

Figure 7: Change in Real Income by Income Percentile, 2000–2007



Source: Analysis of U.S. Census Bureau data by Jared Bernstein; Economic Policy Institute, www.epi.org/content.cfm/webfeatures_econindicators_income_20080826.

The problem with skyrocketing housing costs is that they do not just build wealth; they also suck up discretionary income. Between 2000 and 2005, mortgage debt as a share of discretionary income grew from 70% to 96%. So people are making their mortgage payment and borrowing to cover the rest of their living expenses. Overall, their lifestyle is costing them 30% more than they are earning. The outcome: colossal debt, a combination of mortgage—now often greater than the value of the home as housing prices decline—and credit card. People had been told that if they got into trouble, they could just sell their house and still be better off than where they started. It sounded good, but when the economy eventually started obeying the laws of physics once again—or, as Manning puts it, went off steroids—the whole structure began to collapse. People were unable to sell their houses; foreclosures mounted; banks lost money on their insanely complicated debt transactions and stopped lending; unable to borrow, people defaulted even more and stopped buying things; and businesses lost money and laid off workers. We have lost nearly two million jobs since the beginning of the current recession. The nation's employers cut over a half million jobs in November 2008 alone, according to the Bureau of Labor Statistics, with the national unemployment rate reaching 6.7%. That figure does not include "discouraged workers," those who have given up on trying to find a job. When those individuals are factored in, the unemployment rate nearly doubles.

And voilà, a serious recession fueled by a combination of banking practices, consumer behavior, and the popping of a double bubble. However, the recession wasn't officially acknowledged until December 1, 2008, when the National Bureau of Economic Research told us that the U.S. economy had been in recession since

Figure 8: Household Assets and Liabilities by Wealth Class in the United States

Assets and liabilities		Top 1%	Top 9%	Next 10%	Next 20%	Middle 20%	Bottom 40%	Average
Stocks †	1962	2617.4	133.9	14.9	4.8	1.2	0.3	41.6
	1983	1699.5	109.7	13.1	5.0	1.7	0.4	30.1
	1989	1282.8	141.0	27.6	9.7	4.0	0.7	31.7
	1998	2743.7	316.7	86.4	29.9	10.0	1.8	78.0
	2001	3568.4	512.3	131.9	41.3	12.0	1.8	106.3
	2004	3276.5	413.4	105.6	31.3	7.5	1.4	89.0
All other assets	1962	2847.4	491.6	233.6	129.9	70.3	16.7	142.0
	1983	6540.8	849.0	343.2	176.6	86.9	18.3	235.8
	1989	9090.9	933.3	368.9	201.5	96.8	21.0	279.3
	1998	8649.8	897.7	360.0	196.8	106.0	25.9	267.3
	2001	9449.5	1221.1	438.4	234.6	113.5	26.6	328.3
	2004	12060.6	1524.7	573.7	305.8	148.4	35.2	420.5
Total debt	1962	193.3	37.8	28.0	29.0	28.7	16.1	25.9
	1983	444.5	74.0	53.5	36.4	28.3	13.6	34.9
	1989	484.7	98.7	53.3	48.2	37.0	26.1	46.3
	1998	307.1	114.0	71.7	51.5	49.7	26.5	51.7
	2001	325.8	122.3	79.9	60.5	50.5	25.5	54.5
	2004	566.8	174.2	103.8	93.8	74.1	34.4	79.1
Net worth	1962	4271.5	587.7	220.4	105.7	42.8	0.9	157.7
	1983	7795.8	884.7	302.8	145.2	60.3	5.1	231.0
	1989	9889.0	975.6	343.2	163.0	63.9	–4.4	264.6
	1998	11086.4	1100.3	374.7	175.3	66.3	1.2	293.6
	2001	12692.1	1611.0	490.3	215.3	75.0	2.9	380.1
	2004	14770.4	1764.0	576.3	243.4	81.8	2.2	430.5

In thousands of 2004 dollars.

† All direct and indirect stock holdings.

Source: Unpublished analysis of Survey of Consumer Finance data by Edward B. Wolff (2004), cited in Laurence Mishel, Jared Bernstein, and Sylvia Allegretto, *The State of Working America* (Ithaca, NY: ILR Press, 2007), 289.

December 2007. By then, of course, most Americans—even those who still had a job and were still able to make their house payments—had already been assuming for months that we were in the midst of a deep recession. The only ones who didn't seem to already know the United States was in recession were the mainstream press and certain high-profile candidates for public office. It was certainly clear to bankers, as some of the industry's heaviest hitters began hemorrhaging money. By mid-December 2008, 25 U.S. banks had failed during the year, a number that exceeded the total for the previous six years combined. Two of the year's casualties, Washington Mutual and IndyMac, are among the biggest bank failures in history. On November 25, the FDIC classified 171 banks as "problem" in the third quarter, signaling that more failures could be on the horizon.

Even before final negotiation of the gigantic federal bailout package for the financial industry, the government had stepped in to bail out a number of large financial institutions deemed "too big to fail." They included the huge insurer AIG, the investment bank Bear Stearns, and the government-supported entities Fannie Mae and Freddie Mac. Banks must now struggle with the challenge of finding capital to fuel their recovery in an environment where few players have capital to invest, and those that do are hesitant to lend it to other institutions whose ability to repay remains in question.

Understanding how the United States got here does not necessarily point us toward any obvious solutions. The recession, by now

COLLOQUIUM INTERACTIONS

Audience: I think the factor that we don't always necessarily count on is the consumer behavior. Consumers are pulling back. Can you give me the doomsday scenario, worst-case scenario, if you see this consumer behavior continuing and really pull back from spending?

Max Wolff: OK, it is a great question. The worst-case scenario, by the way, is not that people save money and put it into credit unions and banks. The bigger fear is that people have sudden, forced reduction in spending, not so much because they are saving, because they have no money, right, and what little money they do have becomes disintermediated. In other words, they don't even bring it to the institutions.

Here I think credit unions have a good position, because people are not seeing credit unions go under, and not panicking.

However, the bad-case scenario, which does look pretty much like it has arrived, is that there will be a massive reduction in American purchases for goods and services. That will back up around the world. So when Americans don't buy, it means production facilities closing down around the world, which reduces the demand for raw materials in the developing world, which sends shock waves into marginal developing countries or emerging market economies, and which eventually pushes down their assets.

And that can create a global beggar-thy-neighbor policy package, in which everybody tries to devalue their currency and either dump goods through export on the global market or prevent other peoples' exports from coming in to save themselves, at the cost of everyone else. That is your slippery slope to global confrontation of a possibly military variety.

That's what you want to avoid. Significant trade wars have a nasty time-honored history of becoming wars that aren't fought out only by commerce departments, but involve other departments with a different arsenal at their command. And so what you don't want now is beggar-thy-neighbor generally acknowledged as the worst American economic crisis since the Great Depression, was years in the making, and it will not be fixed overnight. But by recognizing the failures, bad acts, wrong assumptions, and unavoidable blind spots that got us into this predicament, the conversation can get started about the role credit unions can play in helping the public—and ourselves—weather the storm, and perhaps learn a little about how to avoid the same traps in the future.

COLLOQUIUM INTERACTIONS (CONTINUED)

policy, and there is some reason to be somewhat hopeful there.

We do seem to have an incoming administration that is more multilateral and that is tapping a different cross-section of expert opinion than the outgoing administration. And also, the new administration tends to be seen in a more positive light around the world than the outgoing administration, which was not enormously globally popular.

So there are some reasons not to think that the worst-case scenario is an inevitable fact, but there is going to be a minimum multiyear very, very severe recession. My personal opinion is that a whole large segment of the consumption and retail economy of the United States is going to go through in the next five years very quickly what heavy industry in the upper Midwest went through in the '70s. It is going to be shattered.

You are going to have dead malls and closed big-box retailers. For instance I would personally be very surprised if four or five large household-name retailers weren't bankrupt after the holiday season. I am not talking about going into bankruptcy and then coming out in three years; I am talking about a terminal liquidation bankruptcy that would commence within a month or two of Christmas.

So I think unfortunately this is already snowballing. The object rolling down the hill seems to be growing, and so I do think that is going to happen. But inside any kind of crisis is also opportunity, and the footing we have been on was unsustainable, irresponsible, and unhealthy for the country.

So finding ourselves forced to make the change, even though it is painful, and this would never be the way you would plan it or want to see it happen, it is still something that eventually had to be done and we can sort of seize the opportunity that slumbers within a very painful crisis.

So I am not sure that it is all bad news, but I couldn't tell you with real honesty that it looks particularly good either at this point.

CHAPTER 2
The Brave New World of Financial Services

The financial services landscape has changed, and will continue to change. The regulatory environment and competitive landscape are about to shift dramatically. There are also changes taking place in the way consumers are handling their money, with incomes shrinking, retirement investments under threat, and job security a serious concern for many Americans.

With these macroeconomic developments in mind, it is easy to see that the playing field for financial services will be fundamentally altered; consequently, it should not be a surprise to see some new players take the field. So given the set of circumstances the United States now finds itself in, what is the potential impact of Wal-Mart's entry into the financial services business? Needless to say, the implications are quite different from what would have been expected when the question was first asked a few years ago. But by looking at Wal-Mart's early small steps in the United States and the major inroads it has made in Mexico, you can draw some conclusions about the company's U.S. financial services intentions, and what its actions could mean for the industry as a whole.

COLLOQUIUM COLLABORATORS

This section draws from presentations by Stephen LaGrou, Kathleen Keest, Bill Hampel, and Lois Kitsch.

Stephen LaGrou is a visiting lecturer in business legal studies and accounting at RIT. He is also an attorney. LaGrou's areas of expertise include business law and fixed-income securities and derivatives.

Kathleen Keest is a senior policy counsel at the Durham, North Carolina–based Center for Responsible Lending, a nonprofit, nonpartisan organization dedicated to combating abusive financial practices.

Bill Hampel is the senior vice president of research and policy analysis and chief economist for the Credit Union National Association (CUNA). Prior to his work at CUNA, Hampel was an assistant professor of economics at the University of Montana and an economics instructor at Iowa State University.

Lois Kitsch joined the National Credit Union Foundation as national program manager of REAL Solutions in December 2006. In her prior role as director of field projects with the Filene Research Institute, she piloted the REAL Solutions program in three leagues that implemented and tested new business models designed to serve new target markets, including young adults, immigrants, and modest-income households.

Why would Wal-Mart want to get into banking? The short answer is that there are some 40 million people who are already Wal-Mart customers and are either unbanked or underbanked. Of course, it works the other way as well. Banking customers would increase store traffic and likely buy a lot of merchandise on impulse. Moreover, because of the sheer number of people who walk into a Wal-Mart every day, there is an opportunity to apply the same high-volume, low-margin model to banking that has been so successful in its retail business. Wal-Mart could be in a position to charge substantially lower fees than other providers and still turn a profit on those services. And because it is already well established as a financial services provider in Mexico, Wal-Mart stands to capture a large portion of the $250B market in cross-border remittances.

Wal-Mart already offers an array of financial services in the United States: check cashing, money orders, bill payment, and money transfers. There are 500 in-store MoneyCenters, and plans are in place to open 500 more within a year or so. It currently offers two credit cards—a regular Discover card and a dedicated store card good only at Wal-Mart. It also has the Wal-Mart MoneyCard, which is essentially a prepaid Visa card that functions similarly to a bank debit card. Since it began offering the MoneyCard in June 2007, over a million have been sold, and over $1B has been loaded onto them.

Legal Issues

To date, Wal-Mart has encountered obstacles in getting the charters it needs to fully dive into banking in the United States. Its response to these barriers has been to partner with other companies. In addition to partnering with Visa, it has partnered with ShareBuilder from ING Direct, a discount brokerage outfit. This relationship allows customers to access a money market and to also use their MoneyCard to make contributions to their IRA account. Wal-Mart's financial services business currently handles 2.5–3.5 million transactions every week, and activity is growing very rapidly.

As Wal-Mart seeks to expand the range of financial services it offers in the United States, the type of institution it currently appears most interested in forming is an industrial loan company (ILC). An ILC is a state-chartered financial institution that is eligible for FDIC insurance but is not a bank under the Bank Holding Company Act, mainly by virtue of not accepting demand deposits. By avoiding the bank classification, ILCs escape a considerable amount of regulation by the Federal Reserve Board; their main federal regulator is the FDIC. And an ILC, unlike a bank, can be owned by a commercial entity that is not a financial institution. That would seem to make the ILC structure a good fit for Wal-Mart. ILCs are currently authorized in only seven states. There are a variety of other subtle legal distinctions between a bank and an ILC, but from a consumer's perspective, there really is not much difference. ILCs cannot accept demand deposits, but they can offer products that are quite similar, such as NOW accounts and the like. Figure 9 outlines some of the key differences between banks and ILCs.

Figure 9: Comparison between Commercial Banks and ILC Charters

Powers	State commercial bank that is a Bank Holding Companies Act (BHCA) bank	Industrial loan company (or industrial bank) that is not a BHCA bank
Ability to accept demand deposits	Yes	Varies with the particular state. Where authorized by the state, demand deposits can be offered if either the ILC's assets are less than $100M or the ILC was acquired before August 10, 1987
Ability to export interest rates	Yes	Yes
Ability to branch interstate	Yes	Yes
Ability to offer full range of deposits and loans	Yes	Yes, including NOW accounts, but see the first entry above regarding demand deposit accounts
Authorized in every state	Yes	No. ILCs currently are chartered in seven states*
Examination, supervision, and regulation by federal banking agency	Yes	Yes
FDIC may conduct limited scope exam of affiliates	Yes	Yes
Golden Parachute restrictions apply	Yes	Yes, to the institution; no, to the parent
Cross Guarantee liability applies	Yes	No
23A & 23B, Reg. O, CRA apply	Yes	Yes
Anti-tying restrictions apply	Yes	Yes
Parent subject to umbrella federal oversight**	Yes	No
Parent activities generally limited to banking and financial activities**	Yes	No
Parent could be prohibited from commencing new activities if a subsidiary depository institution has a CRA rating that falls below satisfactory**	Yes	No
Parent could be ordered by a federal banking agency to divest of a depository institution subsidiary if the subsidiary becomes less than well capitalized**	Yes	No
Full range of enforcement actions can be applied to the subsidiary depository institutions if parent fails to maintain adequate capitalization	Yes	Yes
Control owners who have caused a loss to a failed institution may be subject to personal liability	Yes	Yes

NOW = negotiable order of withdrawal; CRA = Community Reinvestment Act.

* California, Colorado, Hawaii, Indiana, Minnesota, Nevada, and Utah.

** Parent, with respect to a state commercial bank, refers to a bank holding company or financial holding company subject to supervision by the Federal Reserve. Under a proposed rule, broker-dealers who own ILCs may soon be able to choose consolidated supervision by the Securities and Exchange Commission. See "Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities," 62 Fed. Reg. 62872 (to be codified at 17 C.F.R. Part 240).

Source: Federal Deposit Insurance Corporation, Supervisory Highlights.

Several times in the last decade, Wal-Mart has made moves aimed at establishing itself as a bank. In 1998 it tried to buy a small thrift in Oklahoma, but that effort was blocked by the Office of Thrift Supervision. An attempt to buy a small, troubled California industrial bank in 2002 was thwarted by the California legislature. And its proposed joint venture with a subsidiary of Toronto-Dominion Bank was stopped by regulators as well. In July 2005, Wal-Mart applied to the FDIC and the State of Utah for an ILC charter, Utah being particularly friendly to the formation of ILCs. In direct response to Wal-Mart's move, a number of states passed laws banning branches of ILCs chartered in other states, though these laws may eventually be thrown out, as they appear to violate a federal statute prohibiting states from treating out-of-state branches differently from in-state branches.

> Wal-Mart would create one-stop shopping for financial services, tap into this 40 million unbanked people. Wal-Mart can offer extended hours that a regular bank may not be able to match. And there is a possibility of low fees if Wal-Mart carries their price cutting model to this area, but it's not clear whether that would happen.
>
> They are certainly capable of delivering services that way. The advantages for Wal-Mart obviously are fee income. One other advantage . . . is that if they rely on capital rather than on deposits, they can sometimes earn a higher ROA (return on assets). And that did happen with GE Capital Financial.
>
> —*Stephen LaGrou (presentation at colloquium)*

In a move generally perceived as being directed squarely at Wal-Mart, the FDIC imposed a moratorium on new ILC applications in 2006, ostensibly to give Congress time to study whether ILCs represented unfair competition to banks. The moratorium was extended for another year in 2007. Meanwhile, Wal-Mart withdrew its ILC application in March 2007.

Strategic Considerations

What would having Wal-Mart plunge fully into the financial services business mean for consumers and for the rest of the industry? There are pros and cons. On the positive side, Wal-Mart could offer extended hours that a regular bank would be unable to match. Its ability to offer one-stop shopping for financial services would be extremely convenient to customers who already shop at Wal-Mart. It is also possible, depending on whether Wal-Mart chose to adopt a low-cost, high-volume model, that competition from Wal-Mart could lower fees across the financial services industry.

On the other hand, there are dangers to the combination of banking and retail services in the hands of one gigantic player. Wal-Mart could make loans preferential to its own customers, putting competitors at a disadvantage. Wal-Mart's low-cost model could conceivably push small community-based banks and credit unions out of business, as has already happened with Main Street retailers across the country. So it's possible that some communities would lose important sources of capital for local economic development. And the fact that ILCs are regulated not by the Federal Reserve but by less stringent FDIC standards could be cause for concern for smaller community-based financial institutions.

So while there are plenty of reasons to be apprehensive about Wal-Mart's foray into financial services, consumers could very well benefit in some ways. Nobody wants to see the locally owned neighborhood hardware store go out of business a year after Wal-Mart opens on the outskirts of town; but it's hard to dispute the fact that, in many cases, Wal-Mart is able to give customers better value. If Wal-Mart is able to give consumers a better deal on financial services than the credit card issuers and payday lenders they are currently doing business with, it may not be such a bad thing.

> The effect of Wal-Mart coming would be greatest, of course, on the smallest institutions. Historically it's the small competitors that Wal-Mart gives the most difficulty to. In this case it would be in terms of efficiency. This is exacerbated by the recent trend in financial services of stretching economies of scale.
>
> —*Bill Hampel (presentation at colloquium)*

Of course, whether Wal-Mart would indeed go with a low-price model remains an open question. Essentially, there are two types of players when it comes to financial services. The good guys, for the most part, are banks and credit unions. They offer opportunities to build wealth through deposit accounts and make loans at competitive rates. Then there are the bad guys (though obviously not everybody considers them bad guys): payday lenders, rent-to-own outfits, and check-cashing operations. These types of businesses serve low- and moderate-income people by offering loans at exorbitant rates to consumers who don't have other options. They extract money from customers and offer no real asset-building opportunity in return.

Then there is a middle ground. Suppose an institution that offers deposit accounts and a means of accumulating wealth looks over at the payday lender next door one day, sees how much money its neighbor is making, and decides that it can come up with its own version of the payday lending scheme. That is essentially what has happened with overdraft fees. By providing a service billed as a great “favor” to customers by sparing them the embarrassment of bouncing checks, depository institutions have created a system that basically ends up costing customers as much as if they had borrowed from a payday lender to pay their bills instead of just writing a check and paying the overdraft fee. Overdrafts have a cascading effect similar to payday loans; they are disproportionately applied to poor, elderly, and minority individuals; and, similar to payday loans, they trap consumers on a treadmill that is exceedingly difficult to dismount. Imagine the following scenario for a Social Security recipient. A woman was charged $448 in fees for three overdrafts, leaving her with only $18.48 in her account at the end of two months. If the bank had instead given her a line of credit at 18% to cover those bills, she would have had $420 at the end of the two-month period. Had the bank just let the three overdrafts go, and assuming the customer paid late fees, she would have had $489 in her account after two months.[2] This is the bank version of payday lending in action.

The other kind of credit Wal-Mart could choose to compete with is credit cards. The big danger with credit cards is the “universal default,” where initially a lender offers a competitive rate up front, but if the customer makes a single late payment, the rate increases dramatically. This “penalty” rate, like the usurious rates attached to short-term payday loans, is exactly the kind of arrangement that lands customers in quicksand they may never escape from. As with overdraft fees, minorities, low-income workers, and single parents are especially vulnerable to falling into the universal default trap.[3]

Wal-Mart’s eventual impact on financial services will largely be determined by the company’s strategic choices with regard to where it chooses to position its practices on the “good guy” to “bad guy” continuum. But make no mistake—it is entirely possible that for a sizable demographic of unbanked and underbanked individuals, Wal-Mart could represent a significant improvement over the types of alternative financial service arrangements they currently have access to. And because it has thus far been rebuffed in its attempts to fully enter the U.S. banking market, Wal-Mart has to date mainly offered the kinds of services used mostly by lower-income people, and marketed those services toward that demographic. Compared with most of the alternative financial sector, Wal-Mart’s fees for things like remittances, bill paying, money orders, and check cashing are very attractive. They are even attractive compared with fees charged in the mainstream financial sector.

Lessons from Wal-Mart in Mexico

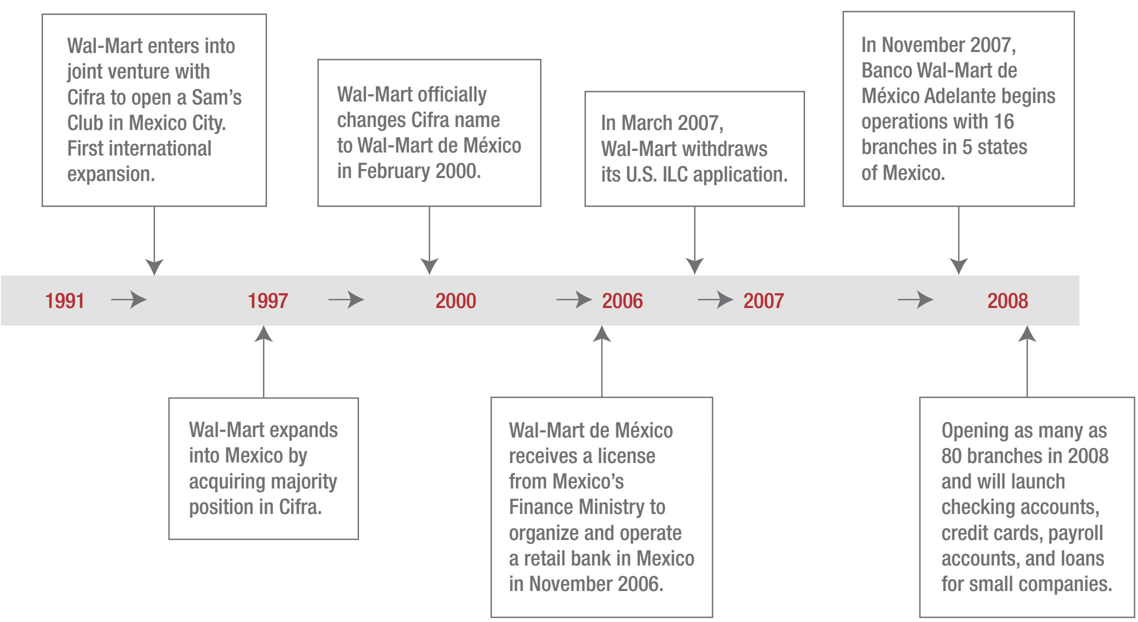
Perhaps the best clues as to what Wal-Mart will try to accomplish and what the impact will be can be found south of the border. Wal-Mart de México received a license from Mexico’s Finance

Ministry to organize and operate a retail bank in November 2006. It launched its Mexican banking operation in November 2007 and began issuing credit cards the following year. For the first three quarters of 2008, Wal-Mart's Mexican banking unit generated revenues of 15 million pesos ($1.1M), mostly by targeting the 75% of Mexico's population that had never previously had a bank account. Figure 10 outlines the significant steps toward Wal-Mart's entry into Mexico's banking industry.

As Wal-Mart attempts to import its Mexican success into the United States, a key issue will be its strategic decision as to how financial services relate to its retail business. To what degree will financial services be a loss leader primarily designed to bring people into the store to make purchases? To what extent does it expect to rely on unbanked lower-income customers, as opposed to working toward providing the kinds of services likely to attract middle-class and higher financial clients?

One key development in Mexico is that Wal-Mart seems to be seeking to expand its scope as a retailer even further, and financial services are facilitating this. For example, you can buy a car through Wal-Mart and it will handle the financing. So, as Manning put it, "The whole point is to get you to buy everything you possibly need or want from Wal-Mart and they're going to figure out the financial services associated to it." As for whether it is applying a cost-cutting

Figure 10: Banco Wal-Mart Timeline



model in its financial services operations, at this early juncture, the answer appears to be "not very much." It is essentially matching what its competitors are doing.

So what do Wal-Mart's activities thus far in offering these services mean for credit unions? While credit unions have historically served the middle part of the income distribution, mostly as a result of their history of employer affiliation, credit unions now aspire to serve the same lower-income population that Wal-Mart is currently targeting.

> For credit unions to survive in this landscape I think there are two things we need: one is much greater collaboration to take advantage of the stretching economies of scale, and then concentrating on our historical strength, which is high-quality services, not-for-profit cooperative focus on the members, and some form of member intimacy or relationship with members.
>
> —*Bill Hampel (presentation at colloquium)*

There are basically two models for credit unions to follow in branching into services for the lower half of the income distribution. The traditional model is to find unbanked people and convert them into credit union members. The second model is to meet the unbanked on their own territory and offer them, in a credit union way, services they are used to getting elsewhere. This, as we will discuss shortly, is the approach the REAL Solutions program exemplifies. The idea is that if only these people knew about the wonderful, low-cost services credit unions have to offer, they would happily come on board. What sets credit unions apart from alternative financial services and from Wal-Mart is that credit unions have no interest in exploiting their members. Fairness is a core value for credit unions, whereas the core value for Wal-Mart is profitability, period. Unfortunately, customers are not always rational, so other factors come into play. For example, it is common knowledge that short-term loans are a bad deal, and yet many consumers are hooked on them as bridges to the next paycheck, even when they have other options. Why do they make these seemingly irrational choices? It appears that some people do not trust themselves to make regular payments on a longer-term loan, so the hammer of having to repay a loan right away is attractive to them even though it ultimately costs them more. One option would be to "trick" consumers into working with credit unions to make more responsible decisions. For example, credit unions could offer a short-term loan that after two weeks could roll over into a regular loan with a reasonable interest rate.

In the next section we report on two prescriptive opportunities for credit unions to consider as they strive to serve the type of consumer

Wal-Mart is expected to court. We begin with REAL Solutions, a nationwide low- and moderate-income outreach program. Next we present Responsible Debt Relief, a proactive debt counseling program to help stressed consumers. While there are many tactics credit unions can employ to serve this market, the colloquium only focused on these two unique initiatives.

REAL Solutions

The REAL Solutions approach is to meet the unbanked on their own territory and offer them a better version of the services they are accustomed to receiving from alternative financial entities. Once they develop a relationship with a credit union, they can then graduate to a more standard checking account relationship. REAL Solutions, a signature project of the National Credit Union Foundation, offers some possible answers with regard to the challenge of serving and ultimately recruiting as members working people of modest means. REAL (**R**elevant, **E**ffective, **A**sset-Building, **L**oyalty-Producing) Solutions is a program whose genesis goes back to a Filene study several years ago of check cashing, the number one service used by unbanked consumers. That study led to an understanding that credit unions offering check-cashing services had an opportunity to

COLLOQUIUM INTERACTIONS

Lois Kitsch: How many of you are doing a payday lending program?

Audience Member: We do; it's a $500 line of credit. It used to be a $500 loan, but we've changed it and it's a line of credit.

Lois: Does it have to pay to zero?

Audience Member: It does have to pay to zero over three months.

Lois: So the member has an opportunity to have access to small loans at much lower cost than they would pay a payday lending store. How many of you think your members go to payday lending stores?

Audience Member: They all do. Every credit union would find members using payday lenders if they looked through ACH. In New York we don't have payday lenders, but lots of members get access to them through the Internet.

Lois: If your credit union is not offering a payday lending program, go out and look at our www.ncuf.org. The Web site can give you all kinds of ideas on this, specifically on how to provide access to used car loans for low score and thin file members. People who have a low credit score or who have a thin score oftentimes are paying very high amounts of money for cars that don't function properly and then are paying interest rates.

leverage that connection to lower-income people into more substantial member relationships.

Credit unions can also offer savings accounts tailored specifically to the needs of consumers of modest means. Certain savings programs have proved to be an effective way to encourage people with little extra income to put small sums aside. “Pot of gold savings” refers to accounts that are used to save for a specific purpose, such as a down payment on a car or house. They are generally structured to accumulate a target amount, say $5,000, over a specific time frame, perhaps five years. Members can also borrow from the fund during the savings period. Interestingly, some credit unions offer higher interest rates for these accounts than for any other accounts. It may seem counterintuitive to offer the best rates on the lowest-balance accounts, but these programs have been quite successful in helping members save.

Check cashing is a service that can provide credit unions with significant revenue and save huge amounts of money for consumers who would otherwise be patronizing alternative check-cashing businesses. By offering the service free of charge to those maintaining a minimum account balance, credit unions incentivize regular users of the service to become members. Charter Oak Credit Union was one of the pilot institutions in the Filene check-cashing study. By providing this service, Charter Oak has generated about $600,000 in fees, saved consumers a similar amount compared to what they would have paid for the service with an alternative provider, and, most importantly, added 2,500 new members.

Another idea gaining in popularity is the prepaid card. Wal-Mart already offers one. One credit union example is the Load ‘n’ Go card, offered by CoVantage Credit Union. The 640 cardholders are mainly people whose credit scores would disqualify them from opening an ordinary checking account. Members pay a $2 fee each time they load the card with funds, as well as a small monthly fee.

A large share of low-income workers rely on payday loan establishments to tide them over from one paycheck to the next. The rates charged by these businesses are notoriously high, yet many unbanked workers do not have much choice but to pay the exorbitant interest. Credit unions have the opportunity to step into this space and provide an alternative to payday lenders’ usurious practices. This can take the form of small loans or lines of credit at rates that are somewhat high but still considerably lower than what the consumer has been paying at the local payday loan operation.

Aside from the financial necessity to attract a new base of members, why should credit unions care about developing relationships with people of modest means? The question really goes to the core of why credit unions are in business in the first place. Credit unions are supposed to care about the communities they are engaged in, even as so many Americans have become disengaged from their own communities. In the groundbreaking book *Bowling Alone* by Robert Putnam, Putnam shows how we have become increasingly disconnected from family, friends, neighbors, and our democratic structures. Today, people are told to save because it is in their own best interest to do so; going into debt will hurt their employment opportunities and make it harder to build wealth for the future. The message was quite different just a couple of generations ago. Young people were told to save because it was their civic duty and because their willingness to put money aside would help their country win a war. Even young children were encouraged to contribute pennies to the cause. By expanding their engagement with the community—particularly lower-income communities and minority communities that have been underserved historically—credit unions have a unique opportunity to restore a relationship that has become all too rare: financial services that treat the customer as a full partner.

Responsible Debt Relief

As levels of debt continue to mount for millions of Americans, especially those toward the bottom of the income distribution, credit unions can play a role in helping consumers manage their deteriorating financial situations by offering responsible debt relief solutions that help members avoid bankruptcy. This issue has become more acute in the last two years. Prior to 2001, during the era of traditional underwriting standards, debt/income ratio was paramount. Eighty to 100% repayment of unsecured debt was typical. Between 2001 and 2006, the laws of financial gravity were suspended. Asset values were inflated on the basis of bloated market values, and debt/income ratio became less of a factor. Most people who got in over their heads could escape by simply refinancing their mortgage; debt repayment became a non-issue.

Now that the financial laws of gravity have returned—or, now that the economy has gone off steroids (pick your metaphor)—typical debt recovery is much lower, 25–40%. The task at hand is to engineer a reasonably soft landing as people speed toward the ground, both helping the consumer avoid bankruptcy and helping the financial institution recover enough of the outstanding debt to maintain its own viability. The quadruple whammy of declining real wages, a plummeting stock market, job insecurity, and declining home values makes necessary a rethinking of how people repay their accumulated debt. The Responsible Debt Relief (RDR) approach recognizes the paradigm shift that has taken place in debt recovery, and applies a more rigorous set of calculations and standards to the problem of finding a mutually beneficial solution for consumers and lenders. The RDR system is an objective and statistically precise estimate of consumer debt capacity and debt repayment capability. Unlike traditional debt collection grading assessments, the RDR program is based on a statistically complex and geographically robust empirical algorithm. This arithmetic estimate of household debt capacity and repayment capability generates two crucially important evaluative assessments: (1) classification of individual consumers into appropriate means-tested debt management/relief programs, and (2) specific statistical estimates of consumers' debt capacity and ability to repay outstanding unsecured debt.

The keys to RDR are:

- Objective, algorithmic estimates of consumers' ability to repay debt.
- Decision-making software that matches consumers to the most appropriate debt resolution program, be it bankruptcy or something less dramatic.
- Business scale to match the needs of the largest credit card issuers.
- A business model that overcomes consumer complaints against debt settlement companies.
- Strategic partnerships between full and partial payment companies.

The RDR program offers the most precise, most objective estimate of the consumer's ability to satisfy a less than full balance payment program. A customized three-year repayment plan is created for each qualifying applicant and is based solely on his or her financial ability to complete the program. The plan is based on a rigorous analysis of

COLLOQUIUM INTERACTION

Audience Member: What does it look like from the consumer's perspective to go through RDR? How is it delivered, and how long does it take from their perspective?

Bob Manning: So, if you are a renter with a simple financial situation: ten minutes to go through the algorithmic assessment. If you're two incomes and you file an itemized tax return and you own a home and all of those things: about 30 to 35 minutes. And we have very trained counselors. We ask them, in fact, "What is your donation to your 401(k)?" We want everybody to have every legal right in terms of what would be the most precise cash-flow estimate after their expenses. I tried to develop something that's fast and efficient to estimate.

such factors as gross household income, estimated after-tax monthly household income, locality-based household budget, average local housing and transportation costs, court-required payments such as child support or delinquent taxes, secured loan obligations, medical/health expenses, allowable federal tax adjustments and deductions, and total outstanding unsecured debts. Consumers eligible for the program must be able to repay 20–60% of their unsecured debts over a three-year period.

As delinquencies on unsecured debt have grown, RDR is proving to be a highly cost-effective strategy for lenders. Without RDR, only 20% of clients achieve 80% repayment. There are also litigation costs and other costs to factor in. With RDR, there is 40–50% repayment for 80% of clients, and no litigation or other overhead costs enter the picture. RDR is currently in full operation in about half the states; another eight are awaiting licensing approval.[4]

Conclusion

While Wal-Mart certainly presents significant competition to the more innovative credit unions seeking to connect with this market, the market may be large enough that it does not matter. It may simply be a matter of setting up shop in the most convenient locations. But what if Wal-Mart's efforts to enter the broader banking sector, offering savings and checking accounts, consumer loans, mortgages, etc., are ultimately successful? Certain trends make Wal-Mart's success less likely, or at least will delay it. Most importantly, in the midst and wake of the current financial crisis, banking is almost certain to undergo a period of dramatic re-regulation. All sorts of new obstacles to entry into the industry could be created. The impact on traditional banking, according to Bill Hampel of CUNA, will not be nearly as significant as the impact we are already seeing of Wal-Mart's activities in serving the underserved alternative financial services market. For one thing, there are already huge players in the banking arena that are applying the high-volume, low-cost model successfully. Credit cards, which seem to follow an economic logic of their own, could be an exception.

The ideas presented above represent just a small sample of what was considered at the colloquium. The financial services landscape has changed, and will continue to change, in a variety of ways this report has barely begun to describe. The regulatory environment is about to shift dramatically. The competitive landscape stands to undergo a major transformation as well, with the collapse of some major players, the combining of others in order to survive, and the possible entry of new huge players from the retail sector. There are also changes taking place in the way consumers handle their money, with incomes shrinking, retirement investments under threat, and job security a serious concern for many Americans. Changes taking place on the macro level suggest that financial services providers should be taking a more consumer-centric view of things. This shift should therefore benefit credit unions and other community-based financial institutions, provided they understand the changes taking place and realize their competitors will eventually figure it out as well. The key is to be responsible and prudent institutions that act with regard to the knowledge that consumers are strapped with debt and their incomes are losing ground to their expenses. The “frothy” credit markets of the past are history (for now), so innovation and empathy to consumers’ behaviors and situations will become increasingly important. Innovation could be the key to future success. That’s a scary word in financial services; after all, innovation is viewed as one of the main causes of the meltdown. Credit unions need innovation with a twist—innovation that makes the needs of consumers the highest priority.

CHAPTER 3
Meeting the Demands of a New Banking Reality

What is the overall impact of macro events taking place in the financial world today, and how can credit unions best adapt to this new financial world order?

“If you are an extraction industry, you better be dealing with a renewable resource.” Kathleen Keest made this comment, likening the new realities facing the financial services industry to those experienced by the petroleum industry. Like energy companies, financial institutions must cope with a competitive landscape that is shifting extraordinarily quickly. Consumer behavior, regulatory matters, and the very structure of the industry are all undergoing major transformations. What began in 2006 as a question about the impact of Wal-Mart’s entry into the U.S. financial system has morphed accordingly into a larger, more critical question: What is the overall impact of macro events taking place in the financial world today, and how can credit unions best adapt to this new financial world order? While the question may have gotten bigger, the answer really has not changed that much: Run your organization as a true fiduciary, provide your members/customers with responsible products that they want and need, involve and educate the media about the good work you do, and take to heart the oft-repeated but seldom-fulfilled maxim that “the consumer is king.” Every crisis carries within it the seeds of opportunity. By acting with regard to the well-being of communities and the households that compose them, we can play a key role in cultivating those seeds.

But make no mistake, the landscape really has changed. Credit has taken on a completely different character. It is no longer something that can be handed out haphazardly—like Halloween candy to sugar-crazed kids. Consumers still need access to credit, but not to support a lifestyle that is out of alignment with their income. They need to borrow simply to pay for the necessities of living. In a sense, the financial services industry may be going “back to the future” by revitalizing old-fashioned concepts of thrift and savings. The competitive landscape has changed as well. While the role Wal-Mart will play remains uncertain, especially given the likely changes in the regulatory environment, credit unions must be prepared to struggle against new contenders for the loyalties of prospective members. In the chaos of the current economic turmoil, it is important not to lose sight of the fact that competitors, new and old, are investing much energy trying to figure out the realities of the new marketplace. Credit unions must do that too, and do it better.

In addition to reacting to external developments, credit unions should strive to be part of the public dialog about how we will respond to financial upheaval, not only as businesses but as community members. Credit unions have an important role to play in helping individuals, families, neighborhoods, and employers navigate some tough financial waters. Credit unions can be proactive about getting that message across to the public by reaching out to the media and making them long-term allies.

Finally, it is important to recognize that innovation is not a luxury, especially during times of jarring change. Many people conflate innovation with recklessness, but this is a mistake. New ideas will not only get credit unions through this hazardous period, but position them to emerge from it with momentum for future growth. Ideas like REAL Solutions, RDR, and Filene's i^3 program will not solve all the problems consumers are facing today, but they represent a smart approach to change; they are investments grounded in a strong understanding of future needs and scenarios.

Few people really like uncertainty. But we live in an uncertain world in uncertain times. You can't run away from it, because it is all around us, in politics, in economics, and even in the weather. So why not use it as an incentive to constantly think a few moves ahead.

1. The higher the Gini ratio, the more income inequality.
2. Kathleen Keest, presentation at colloquium (Rochester Institute of Technology, Rochester, New York, November 2008).
3. Recent legislation will likely sunset this practice by 2011; see www.ncua.gov/news/press_releases/2008/MA08-1218.htm for more details.
4. For more information about RDR programs, see the Filene publication *Responsible Debt Relief: An Algorithmic Assessment of Household Debt Capacity and Repayment Capability,* by Bob Manning.

ideas grow here

PO Box 2998
Madison, WI 53701-2998
Phone (608) 231-8550

www.filene.org

PUBLICATION #180 (3/09)
ISBN 978-1-932795-59-2

filene
RESEARCH INSTITUTE