People of Color and Low-Income Communities Are Disproportionately Harmed by Banking and Financial Exclusion

Access to banking and financial services is essential to economic mobility and opportunity for all Americans. While most American adults are fully banked, barriers to inclusion in banking and financial services disproportionally harm underrepresented and low-income communities:

- Black and Hispanic Americans are more than twice as likely as white Americans to be unbanked or underbanked. Similarly, families at the bottom of the income distribution are more than six times as likely as families at the top of the distribution to be among the unbanked or underbanked.

- Underrepresented and low-income Americans are more likely than their white and more affluent counterparts to have no usable credit score or to be credit invisible.

- The unbanked, underbanked and those with no credit record are forced to rely on costly alternatives that widen existing income and wealth disparities.

- These disparities not only limit the economic participation and financial integration of these underserved Americans, but also limit economic opportunity for all.

- While innovations in financial technology have led to improved equity in some areas, more data and novel algorithms have failed to eliminate discrimination in lending.

- New digital assets in the decentralized finance sector pose serious risks to consumers who need more protection from regulators.

Breaking these barriers to inclusion in the banking industry will require structural policies that directly improve access to banking services and credit, like public banking models. Alternative credit assessment models for the credit invisible are also vital to help these individuals achieve more economic security and build wealth. Yet, persistent racial disparities in wealth will also require new pathways to asset purchase, like helping historically disadvantaged families buy their first home. Lastly, to reward the faith of investors and consumers in key innovations in finance, Congress will have to establish rules to govern digital assets.

INTRODUCTION

More than 80% of adults in the United States are fully banked. These individuals are able to obtain access to banking and credit services to meet their financial needs and build wealth. But the nearly one in five adults that are either unbanked or underbanked are disproportionately low-income and underrepresented Americans who lack access to a bank account or rely on alternative financial services. An estimated 40% of Black Americans, 29% of Hispanic Americans and more than one-third of families earning less than $25,000 annually are either unbanked or underbanked. These underserved communities pay a high price for this exclusion by having to rely on costly alternatives.

People of color and low-income Americans are also more likely than their white and more affluent counterparts to have no usable credit score or to be labelled as "credit invisible" with no credit record. These individuals struggle to obtain mainstream forms of lending, such as credit cards or mortgages. Having little to no credit record can also discourage financially underserved Americans from applying for credit. Underrepresented Americans are on average about twice as likely as white households to not apply for credits cards or personal loans out of fear of being denied. This sense of apprehension may be informed by their experiences in credit markets. In 2021, 46% of Black Americans and 37% of Hispanic Americans reported that they had been denied credit or were approved for less credit than requested, compared to less than 25% of white Americans.

While some innovations in financial technology (fintech) have led to improved equity, continued disparities in lending show that discrimination and exclusion are not just technological failures. Evidence shows that while fintech algorithms exercise less bias than face-to-face lenders, they fail to eliminate discrimination.

Early evidence from the growing decentralized finance sector also shows that cryptocurrencies and digital assets replicate some of the existing disparities in traditional finance and pose legitimate risks to consumers. Yet, Black and Hispanic Americans are more than twice as likely as white Americans to report that cryptocurrencies present no risk. Providing alternative financial services to these historically disadvantaged communities is essential, as this trust may fail to be met given that the lack of comprehensive regulation in this space exposes investors and consumers to fraud and illicit practices.

Narrowing these disparities in banking and financial access will require bold policies that address long-standing barriers and strengthen investor and consumer protection. For example, a public banking option can bring basic financial services like low-cost savings and checking accounts to post offices. Alternative credit assessment models, can also help banks develop the capacity to issue credit cards to consumers with no credit scores under the current system.

Addressing persistent wealth disparities will also require Baby Bonds and a down payment assistance fund to help historically disadvantaged families purchase their first home. The confidence of underrepresented Americans in financial innovation and dynamism can also be rewarded by improving access to novel platforms and safeguarding their transactions from fraud. These efforts would help underrepresented and low-income Americans save money and achieve more economic security with clear pathways to sustained prosperity.

BANKING AND FINANCIAL EXCLUSION DISPROPORTIONATELY HARMS UNDERREPRESENTED AND LOW-INCOME COMMUNITIES

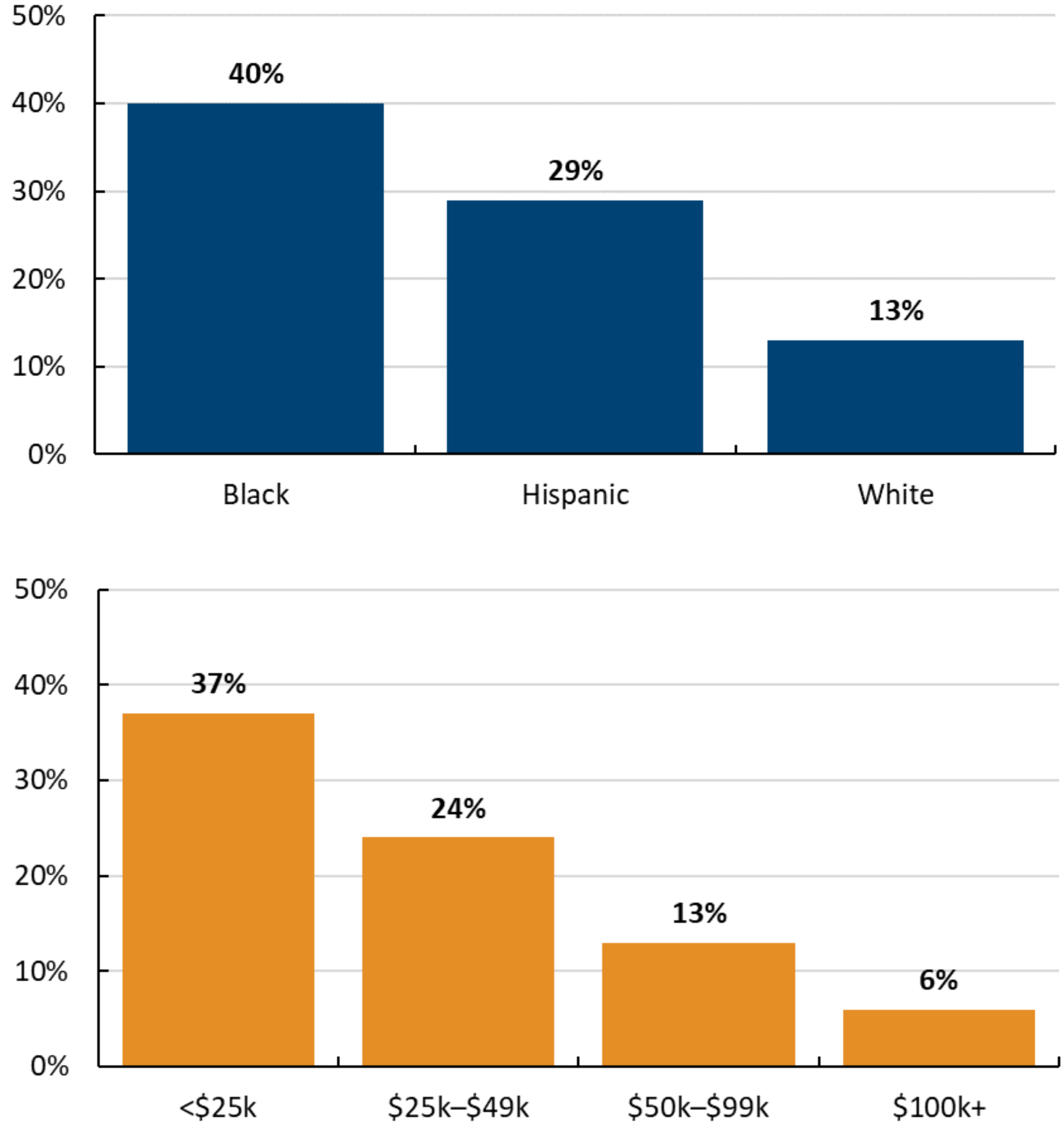
Black, Hispanic and low-income communities are generally more likely to be unbanked and underbanked

Underrepresented and low-income Americans are more likely than their counterparts to face gaps in accessing basic financial services. For example, Black and Hispanic Americans are more than twice as likely as white Americans to be unbanked or underbanked, which forces Black and Hispanic Americans to rely on alternative, and costly, financial services for everyday transactions (see figure below).

Disparities in access to basic financial and banking services are also observed across the income distribution (see figure below). Families earning less than $25,000 annually are more than six times as likely as wealthier ones to be unbanked or underbanked.

Disparities in Access to Basic Financial Services Exist Across Race and Income

Percent of unbanked and underbanked adults by race/ethnicity and family income, 2021

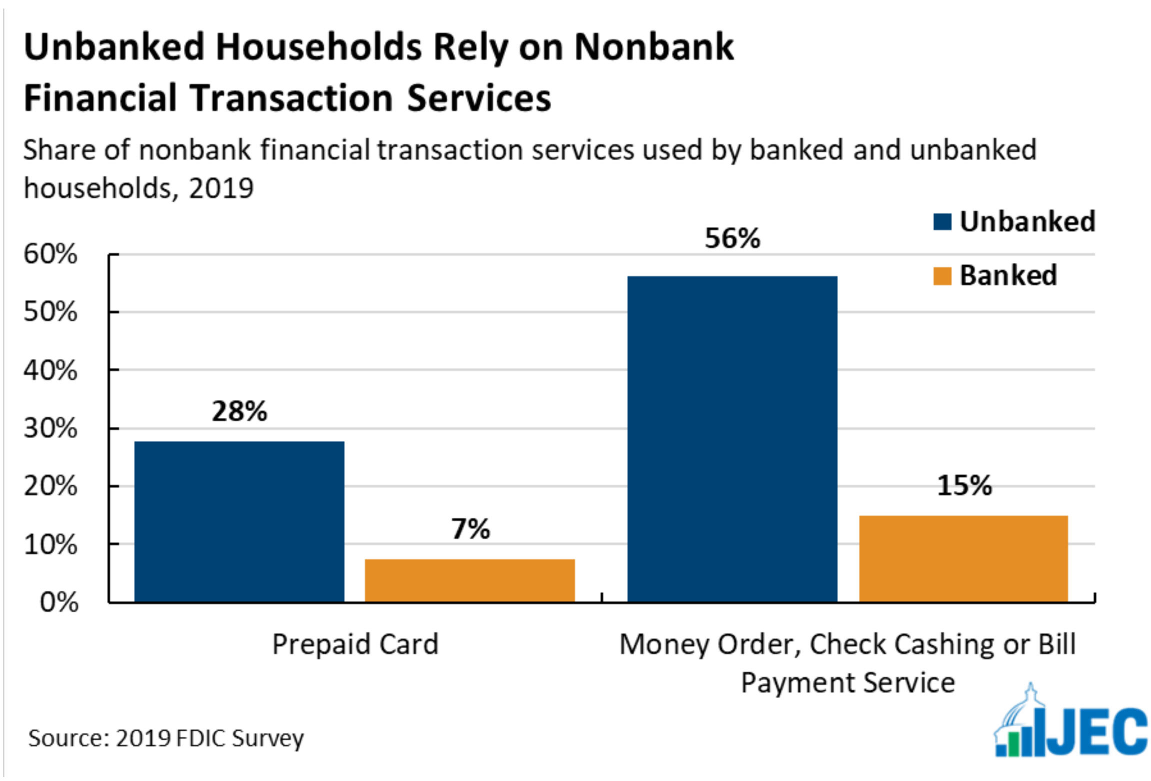


Source: Federal Reserve Board of Governors
Notes: Data represent the total percent of underbanked and unbanked individuals. Underbanked individuals have bank accounts but made use of alternative financial services in the past 12 months. Unbanked individuals do not have bank accounts.

The unbanked and underbanked face barriers to access and pay a high cost for financial exclusion

People of color and low-income communities face pervasive barriers to accessing banking and financial services. For example, banks frequently close branches located in lower-income communities and often have minimum balance requirements and charge account fees. This keeps low-income families on the margins of the financial system. Nearly 40% of unbanked households identify not having enough money to meet minimum balance requirements, inconvenient banking locations or high account fees as a key barrier to financial inclusion.

Unbanked and underbanked individuals and families incur steep economic costs for living on the margins of the financial system, which includes relying on predatory lending schemes that charge costly penalties and trap people in cycles of debt. In many Black and Hispanic communities, check cashers and payday lenders are more common than bank branches and offer more accessible hours. Before the pandemic, more than one-quarter of unbanked households relied on prepaid debit cards compared to just 7% of banked households, and over half of unbanked households used a money order, check cashing or bill payment service, compared to just 15% of banked households (see figure below). These alternative financial services are accompanied by high upfront fees which trap people in cycles of debt and take large percentages of their paychecks. Prior to the coronavirus pandemic, financially underserved, unbanked and underbanked Americans spent an estimated $189 billion in fees and interest on financial products. These predatory practices only exacerbate existing racial and wealth disparities.



For the unbanked and the underbanked, any form of financial activity, such as accessing the funds from a check received, is more arduous and costly. Banked individuals can often pay their bills online and enjoy access to automatic transfers, direct deposit and mobile check deposit, all of which enable them to economize and simplify their financial management. Individuals relying on alternative financial services often do not have access to these same tools. This financial divide was on full display at the height of the coronavirus pandemic. Americans with bank accounts received their Economic Impact Payments through direct deposit, enabling them to address pressing expenses more swiftly and efficiently. In contrast, unbanked individuals had to wait weeks for paper checks to arrive by mail and were also forced to pay a fee to access the money at a check-cashing store.

People of color and low-income Americans are also more likely to have no usable credit score or to be credit invisible

Access to affordable credit helps individuals and families to weather economic shocks and provides pathways to wealth-building investments that facilitate enduring financial stability. But the current credit scoring system presents barriers to financial inclusion for underrepresented and low-income communities. As many as 50 million consumers do not have a usable credit score or are credit invisible, and they are disproportionately people of color and low-income Americans that are held back from participating in our economy.

Consumers with little to no credit history can be grouped into two camps, the "credit invisible" and the "unscorable." The first is comprised of consumers without a credit record in any of the three nationwide credit reporting agencies (NCRAs): Equifax, Experian, and TransUnion. These individuals are described as being "credit invisible," since lenders often use credit scores derived from NCRA records when deciding whether or not to approve a loan and in setting its interest rate. The second group includes consumers whose NCRA records are considered "unscorable" because they do not have sufficient credit histories to generate a score. Like the credit invisible, these consumers are less likely to obtain credit from lenders.

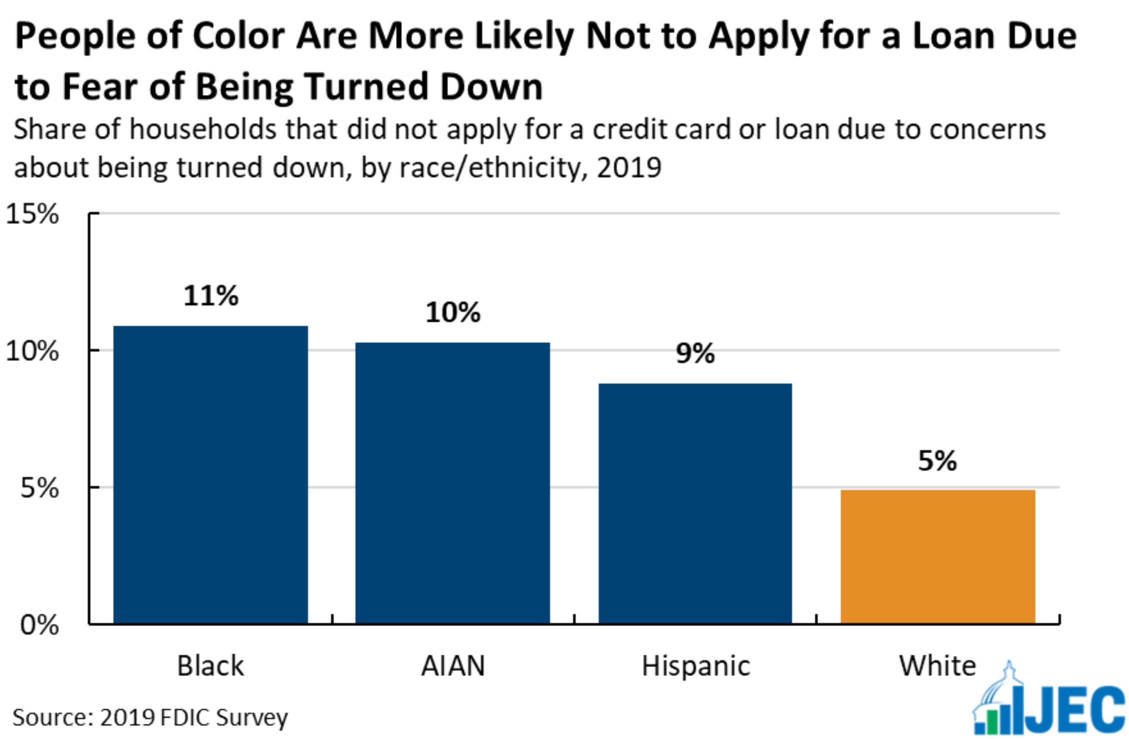
Low-income and underrepresented Americans are more likely than their counterparts to be counted among the credit invisible and those with no usable credit score. Nearly half of consumers in low-income census tracts appear to either lack a credit record entirely or have an unscored credit record. Black and Hispanic Americans are also more likely to be credit invisible or to have unscored records than white Americans. About 15% percent of Black and Hispanic Americans are credit invisible, compared to less than 10% of white Americans. An additional 13% of Black Americans and 12% of Hispanic Americans have unscored records, relative to less than 7% of white Americans.

Challenges in accessing the credit scoring system impede financial integration and wealth creation in marginalized communities

Individuals at the margins of the financial system are often unable to obtain mainstream forms of lending, such as credit cards or mortgages and face an uphill struggle in obtaining short-term liquidity and building wealth. These consumers are often forced to turn to predatory forms of lending such as payday loans. These lending vehicles typically come with steep financial costs. A large share of payday loan users conduct transactions on a long-term basis, as they are unable to pay back the initial loan in full and meet their credit and financial needs without subsequently taking out a new loan.

Black and Hispanic Americans are more likely than white Americans to rely on high-cost, single payment credit products and other alternative financial services. Black households are 2.7 times more likely than white households to use pawn loans. Similarly, Hispanic households are 3.1 times as likely as white households to use payday loans. In 2020, Black and Hispanic households spent $127 billion in interest and fees for everyday financial services.

Having little to no credit record can also discourage underrepresented Americans from applying for credit. Black, Hispanic and American Indian and Alaskan Native (AIAN) households are nearly twice as likely as white households to not apply for credits cards or personal loans out of fear of being denied (see figure below). Households in the bottom of the income distribution are also more likely to share this concern relative to their more affluent counterparts.



The apprehension that underrepresented communities report in being turned down for credit card or personal loans may be informed by their experience with credit markets. Black and Hispanic households are more likely than white households to be denied or not receive as much credit as requested when applying. In 2021, 46% of Black Americans and 37% of Hispanic Americans reported that they had been denied credit or were approved for less credit than requested, compared to 22% of white Americans. This racial gap in credit access widens for consumers with family income greater than $100,000.

NARROWING GAPS IN BANKING AND FINANCIAL EQUITY WILL REQUIRE POLICIES THAT ADDRESS STRUCTURAL INEQUALITIES AND ENHANCE CONSUMER PROTECTION

New lending rules and public banking options can expand access to banking for all

Disparities in access to credit and banking and wealth reflect persistent structural inequities that require policy attention, not just technological innovation.

The Biden administration, the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Insurance Deposit Corporation recently announced plans to reform rules under the 1977 Community Reinvestment Act (CRA) in an effort to promote financial inclusion in low-income communities. The CRA intended to end banking and lending practices aimed at excluding low- and moderate-income areas that are often predominantly composed of people of color. These rules were last reformed in 1995 and face increasing need for re-examination as the rise of online banking and financial services have yet to close pervasive gaps in lending.

Mehrsa Baradaran and others have also proposed a postal banking model that could provide low-income and underrepresented Americans with affordable access to a broader array of financial products and services. Wider access to bank accounts, small loans and check cashing would facilitate the disbursement of policy interventions, like stimulus-related checks or payments from the federal government, disbursements of earned income tax credit and/or child credit payments.

The Postal Banking Act can serve as a road map for bringing basic financial services like low-cost savings and checking accounts to post offices. Additionally, the bill would allow the Postal Service to offer small-dollar loans that could eliminate the market for payday loans. Similar proposals have called for the creation of Fed Accounts, which would be free bank accounts for every American set up by the Federal Reserve and run through post offices. A different proposal, the Public Banking Act, would enable establishment of public banks that could interact with postal banking infrastructure and be part of the Federal Reserve system.

Private bank initiatives, with federal support, can help expand access to credit for the credit invisible

Expanding financial inclusion for low-income and undeserved communities will require identifying alternative credit assessment models. This is one of the main objectives of the Office of the Comptroller of the Currency (OCC)'s Roundtable for Economic Access and Change (REACh).

The OCC's Project REACh convenes leaders from banking, business, technology and national civil rights organizations to reduce barriers to credit for the credit invisible. In an effort to identify alternative credit scoring methods, Project REACh has generated a framework for a pilot program in which some banks and financial institutions will share data on customers' deposit accounts to extend credit to people who have previously lacked opportunities to borrow. While some financial institutions have attempted different scoring systems before with varying degrees of success, this one pilot initiative is designed to be significantly broader. Project REACh and its Alternative Credit Assessment Utility Workstream bring together a wide array of technology and financial entities with the capacity to assess many alternative data sources, including rent and utility bill payments and other direct debit authorizations that can help prove payment history and enhance the creditworthiness of underserved consumers.

Among other initiatives, the OCC's Project REACh is focused on revitalizing minority depository institutions (MDIs). MDIs are a vital source of credit and financial services, helping to drive financial integration. While the number of MDIs have been in decline, and were negatively impacted by the coronavirus pandemic, they serve economically challenged and largely underrepresented communities that have been traditionally underserved by the banking industry.

FINANCIAL TECHNOLOGY AND DECENTRALIZED FINANCE POSE RISKS TO CONSUMERS AND HAVE YET TO SIGNIFICANTLY IMPROVE FINANCIAL INCLUSION

The promise of inclusion by financial technology has not fully materialized yet

Financial technology, also known as fintech, promised improved financial inclusion by relying on new data sources, novel algorithmic techniques and direct consumer relations via mobile applications. While some innovations have led to improved equity in finance, continued disparate outcomes in lending reflect the reality that discrimination and exclusion do not just come from technological challenges.

In some areas of finance, technological innovations have led to measured improvements for underserved businesses and communities. For example, some fintech entities were instrumental during the pandemic in connecting small businesses to desperately needed capital from the Small Business Administration's Paycheck Protection Program. Other financial technology start-ups and groups have built intuitive platforms and mobile applications that help low-income Americans access and manage their Supplemental Nutrition Assistance Program and other benefits. But financial technology companies have yet to fully address the exclusionary practices and outright discrimination that prevent marginalized communities from accessing capital and building wealth.

Studies of discrimination in the mortgage market have consistently found that minority loan applicants are more likely than white applicants to be rejected, even after accounting for income and credit history. Similarly, Black and Hispanic borrowers are more likely to face higher cost mortgages than white borrowers. Lending discrimination in the United States currently costs Black and Hispanic borrowers an estimated $765 million in extra interest per year.

Fintech introduces the possibility that novel methods, like machine learning, can leverage newly available financial data to improve inclusion, but this promise has yet fully to materialize. These new and expanded data may include alternative information that is not included in an individual's credit report, such as cash-flow data, which provides information on inflows and outflows from the bank account of consumers. Yet, more data and new techniques have not eliminated existing biases and disparities. Empirical evidence shows that while fintech algorithms exercise less bias than face-to-face lenders, they fail to eliminate impermissible discrimination; Black and Hispanic Americans still pay more in interest for purchase mortgages and for refinance mortgages originated on fintech platforms.

Researchers at the Federal Reserve Board find that expanded data sources used in fintech and other new algorithmic techniques can amplify existing inequities in financial services, arguing that the algorithms were "effectively moving analog discrimination—such as underwriting discrimination, redlining, and steering—to the digital world and compounding the legacies of structural inequity."

Decentralized finance has yet to improve financial inclusion and can expose consumers to costly risks if left unchecked

Proponents of decentralized finance and the blockchain industry claim the distributive ledger technology that powers cryptocurrencies facilitates financial inclusion among the unbanked, but there is little evidence to support this claim.

Early evidence shows that cryptocurrency replicates some of the existing disparities in traditional finance. Men and individuals with higher levels of both income and education are more likely to know of at least one cryptocurrency than their counterparts who are female or possess less income and education. The gender gap in ownership also mirrors the persistent gender gap in the wider finance and decentralized finance industries; men are more likely than women to own at least one cryptocurrency. The ability of the ecosystem to reach the unbanked is also constrained by the magnitude of the digital divide in the United States because 66% of the unbanked do not have internet access at home and more than one-third of unbanked households do not have access to a smartphone.

People of color may be more exposed to the risks of digital assets. Survey evidence shows that Black and Hispanic Americans are more likely than their white counterparts to be invested in unconventional assets, like non-fungible tokens. People of color are also more likely to identify cryptocurrencies as part of their investment status and strategy. However, cryptocurrencies suffer from significant price swings, rendering them unreliable sources of savings or wealth creation. These price swings also explain why digital assets are primarily used as a tool for financial speculation. Large and small investors buy digital assets hoping that the value will go up and they can cash out their earnings back into the traditional banking system. But this hope can be met with costly risks.

Black and Hispanic Americans are more than twice as likely as white Americans to report that cryptocurrencies present no risk, but digital assets present a series of consumer risks associated with high fees and scam coins. Cryptocurrency users can be subject to excessive transaction fees on payments and transfers. The prevalence of financial scams and damaging hacks can also wipe out value in the cryptocurrency market and hurt consumers. The Federal Trade Commission (FTC) reported a significant spike in cryptocurrency-related scams since 2018. Since the start of 2021, more than 46,000 consumers have reported losing over $1 billion due to scams in crypto. News outlets regularly report on these new scam tokens, highlighting the increasingly common threat they pose to consumers.

Protecting consumers from risks posed by emerging technologies in decentralized finance will require more oversight. One potential solution is the Digital Asset Market Structure and Investor Protection Act. This bill would protect consumers and promote ongoing innovation by incorporating digital assets into existing financial regulatory structures. This requires creating statutory definitions for digital assets and digital asset securities. These are important steps to maximize consumer protection and confidence in an evolving and growing market.

CONCLUSION

People of color and low-income communities face pervasive barriers to accessing banking and financial services. They are more likely than their white and more affluent counterparts to be counted among the unbanked, underbanked and credit invisible. This prevents underrepresented families from meeting their financial needs and building wealth. While the promise of improved financial inclusion via financial innovation and decentralization have yet to fully materialize, there is much Congress can do to narrow the existing gaps. Congress can expand access to banking and financial services with a public banking option, support families in building intergenerational wealth by helping them purchase their first home and protect consumers who venture into promising innovations in finance that will determine future access and participation. Creating pathways for underserved Americans to fully and fairly participate in the economy will ultimately expand economic activity and ensure that economic growth is broad-based and inclusive.