OLIVER WYMAN | ideas42

REIMAGINING FINANCIAL INCLUSION

BRIEF

MARSH & McLENNAN COMPANIES

REIMAGINING FINANCIAL INCLUSION

TODAY

1 IN 3 AMERICANS IS UNDERSERVED

BANKS LOSING

$70
ANNUAL ECONOMIC LOSS PER LMI CONSUMER FOR BANK

BOTH BANKS AND UNDERSERVED CONSUMERS ARE LOSING OUT

UNDERSERVED CONSUMERS LOSING

$1,100
ANNUAL LMI CONSUMER SPEND ON JUGGLING FINANCES*

WITH SOLUTION SET

Most savings go to consumer

INTEGRATED SPENDING, SAVINGS, AND CREDIT

BETTER FEE STRUCTURES

BEHAVIORAL IMPROVEMENTS (AUTOMATION, REMINDERS, RELATIONSHIP-BUILDING)

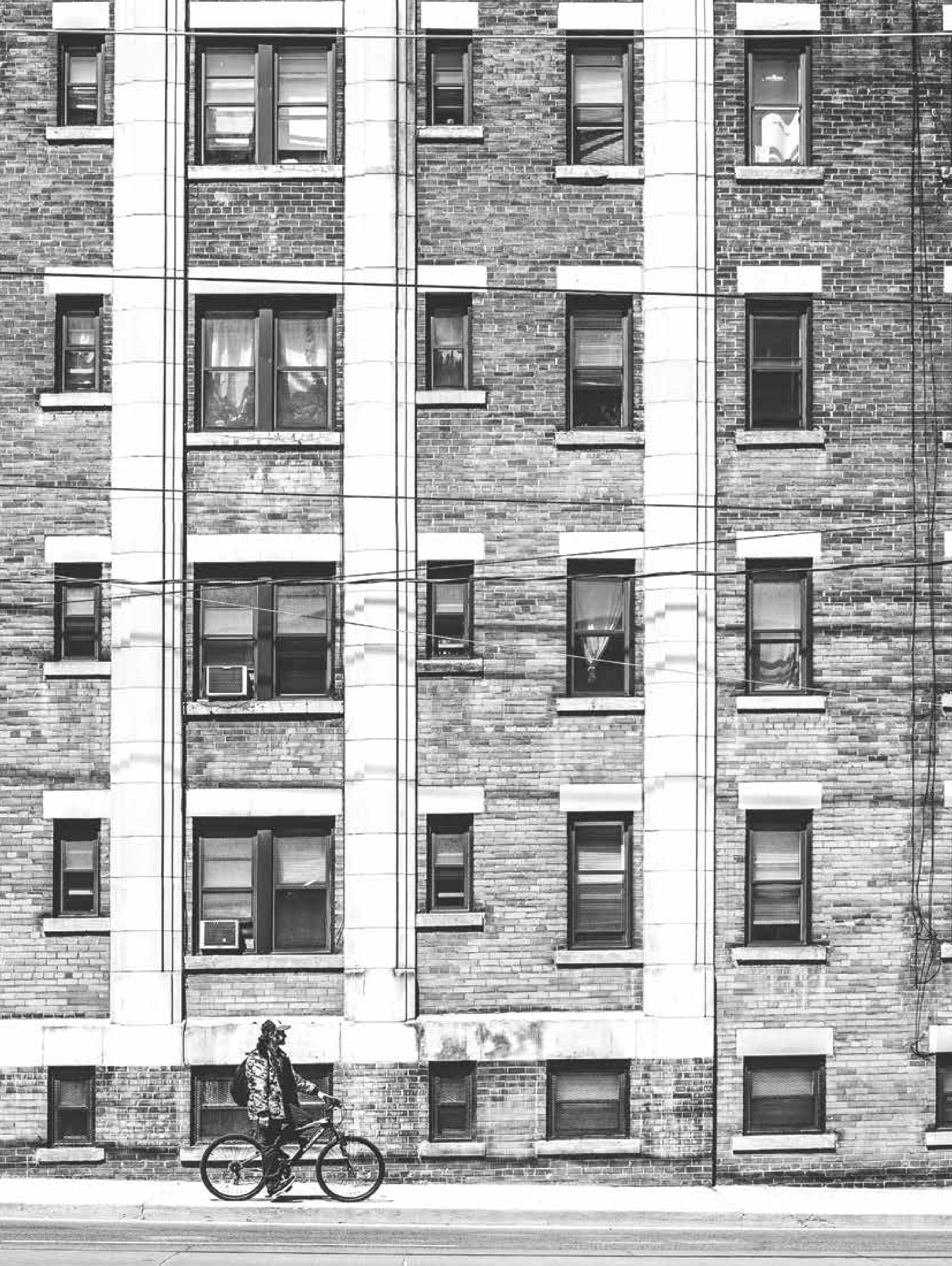
SOLUTION SET INCREASES BANK PROFITABILITY BY **$120 PER YEAR** PER LMI CONSUMER

$1 BN+
PROFIT POTENTIAL FOR A LARGE BANK

CONSUMERS SAVE AN AVERAGE OF **$500 PER YEAR** ON FINANCIAL SERVICES

$15 BN+
POTENTIAL SAVINGS FOR UNDERSERVED CONSUMERS

* Includes fees and interest related to products across a range of providers including payday lenders, check cashing companies, prepaid card providers, banks, etc.



EXECUTIVE SUMMARY

Nearly one in three Americans is "unbanked" or "underbanked" and – despite significant efforts by regulators, consumer advocates, and leading financial institutions – this figure has remained largely unchanged since 2009. So what needs to change to crack the code on financial inclusion? Instead of trying to make lower income consumers fit existing financial products, we propose a new solution set that builds on insights from behavioral science and a deep understanding of financial product economics. This solution, we believe, can help its users improve their financial health and deliver a fair return on capital to regulated financial institutions who offer it.

Advocacy organizations, think tanks, and foundations have been working for years to bring low- and moderate-income (LMI) consumers into the financial mainstream so that they lose less of their scarce income to various types of fees related to managing their finances. Nearly a third of all Americans are considered "unbanked" or "underbanked".[1] We estimate that a typical unbanked household could spend as much as $1,100 juggling finances each year.[2] In total, underserved households spend a staggering $103 BN on fees and interest for alternative and mainstream financial services each year.[3]

Financial inclusion has become a business problem in addition to a social problem, as regulators and consumer advocates increase pressure on financial institutions to change the way they serve lower income consumers. A few large mainstream financial institutions have begun offering innovative products for the LMI community, such as American Express' prepaid card (Serve[4]), J.P. Morgan Chase's prepaid card (Liquid[5]), and Regions Bank's deposit advance product (Ready Advance[6]).

Nevertheless, use of these products is far from widespread, and progress on improving LMI consumer financial health has been truly disappointing.

Rates of unbanked and underbanked consumers in the U.S. remained largely the same between 2011 and 2013, decreasing by just 0.5 and 0.1 percentage points, respectively.

In fact, the small 0.5 percentage point decrease that did occur among the unbanked can be explained by differences in economic conditions and demographic composition of households – indicating that these efforts have had limited impact to date.[7]

THE DILEMMA

Why hasn't there been more progress? Financial institutions find it challenging to serve LMI consumers profitably because of low and volatile deposit balances, high risk, and heavy branch usage, among other factors, and have historically charged high fees to cover their costs. In response, advocates have sought extremely low-priced products and services to protect the interests of LMI consumers. But here we reach an impasse: because of the fundamental economics underlying banking products, financial institutions simply can't afford to offer existing products on the terms that advocates desire.

Ironically, the focus on price has distracted the field from the deeper challenge of designing products appropriately for LMI consumers in the first place.

Further, the latest research suggests that many widespread views about LMI consumers are false:

- Myth: *LMI consumers don't want to save.*
  ideas42's work and external research[8] indicate that LMI consumers often want to save, even when their budgets show little free cash flow.
- Myth: *LMI consumers are bad at managing their finances.*
  Recent research shows that LMI consumers are much more aware of their finances and less susceptible to certain behavioral biases than higher-income individuals.[9]
- Myth: *LMI consumers don't have any money to pay for financial services.*
  LMI consumers pay hundreds of dollars in penalty fees and interest every year, a portion of it going to non-financial firms as late fees. In effect, they pay much more for financial services than the average consumer.

The real challenge facing LMI consumers is clear: they operate in a context of volatility, where cash inflows and outflows are often unpredictable and misaligned, and where small missteps can have serious consequences. This level of complexity would be difficult for anyone to navigate, but the psychological effects of financial scarcity make it especially difficult for LMI consumers to plan for the future – they are often too busy putting out fires in the present.

LMI consumers need a product that can help them manage their cash flow volatility and the behavioral issues this volatility drives.

However, the need to manage volatility doesn't fit neatly into the usual product silos of transactions, credit, deposits, and protection. Traditional banking products designed for middle- and upper-income consumers complicate, rather than simplify, LMI consumers' financial lives. Providing such products to LMI consumers exacerbates the very behaviors (low balances, heavy branch usage) that make these products financially unsustainable for providers and keeps the field from developing better solutions.

BEHAVIORAL SOLUTIONS

Instead of trying to make lower income consumers fit existing financial products, we propose a new type of product that meets the needs of consumers and financial institutions by integrating deposit and credit accounts.

LMI consumers living paycheck-to-paycheck need better tools for managing income and expense volatility. Because this volatility includes both spikes and dips, financial stability requires intervening in good times as well as in bad. In cash-scarce moments, it means providing a way to meet obligations when cash flows are misaligned (credit); in cash-rich moments, it means creating a mechanism for setting aside excess funds between expenses (deposits). When these functions are separate, overdraft fees and interest charges drain value from the consumer. Integrating deposits and credit via a "financial stabilizer" product will encourage beneficial, mutually reinforcing financial behaviors that in turn promote stability for the consumer. Incorporating behavioral design elements such as reminders, spending tools, and automation will further reinforce these positive behaviors.

We understand that the concept described above is complex to design and deliver; however, we believe the potential value justifies the effort.

When consumers have an effective way to manage volatility, many of the problems mainstream financial institutions associate with the LMI population (low and volatile account balances, credit risk) fade.

Seeing more of a consumer's financial life and related behaviors could help institutions screen for credit risk, while automated mechanisms for accumulating savings and replenishing an affordable credit source could directly lower credit risk and expected losses. In addition, offering credit to a consumer appears to drive loyalty and willingness to pay for other services. Finally, an integrated design would reduce much of the "leakage" of funds to product fees, late charges, and overdraft/non-sufficient funds (NSF) fees, as well as capture a larger share of wallet for financial institutions.

With these behavioral innovations, lower income consumers will look a lot more like middle-income consumers, representing a large, relatively untapped segment that can return above-hurdle-rate profits.

A CALL TO ACTION

Behavioral strategies can significantly improve both the product economics and LMI consumers' financial health, but there is a lot of work to be done. Focused testing of novel designs will be necessary to figure out what works. Making sure that these efforts benefit consumers will require coordination among financial institutions, researchers, advocates, regulators, and funders. Challenges to overcome along the way will include organizational obstacles at financial institutions, regulatory concerns, and some stakeholders' insistence that LMI financial products be totally free. If the collective parties do not come together and the economics do not work out, the financial inclusion field could resort to less financially viable approaches such as subsidizing products. This seems unsustainable for the long run and politically unlikely.

Luckily, all of the stakeholders mentioned above have good reason to care about overcoming these challenges. Moving an LMI consumer from a context of extreme volatility to a position of relative stability holds huge economic potential for financial institutions and huge social potential for improving LMI consumers' lives.

Exhibit 1: A New Integrated Banking Solution Set That Benefits Both Banks and Low-to-Moderate-Income Consumers

BENEFITS TO BANKS	SOLUTION SET	BENEFITS TO CUSTOMERS
Better credit screening and lower credit risk	Financial stabilizer product: integrated spending, savings, and credit	Access to credit and better ability to repay
Higher customer engagement and retention	Better fee structures	Trusting relationships and more cognitive bandwidth
More stable deposits	Behavioral improvements	Reduced fund “leakage” and increased resilience

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SOURCES

1 For simplicity, we will refer to these groups jointly as "underserved" in this paper. Burhouse, S., Chu, K., Goodstein, R., Northwood, J., Osaki, Y., & Sharma, D. "2013 National Survey of Unbanked and Underbanked Households." *Federal Deposit Insurance Corporation.* 2014. Web. www.fdic.gov/householdsurvey/2013report.pdf.

2 Includes interest and fees related to check-cashing services, money orders, money transfers, short-term loans, overdraft fees, minimum balance fees, prepaid card loading and usage, and late fees across a range of providers including payday lenders, check cashing companies, prepaid card providers, banks, etc. (sources include USPS, The St. Louis Fed, RiteCheck, MoneyGram, Walmart, JPMorgan Chase, CFPB, FDIC, The Pew Charitable Trusts, USDA, original data from the Detroit Area Household Financial Services Study, and ideas42 and Oliver Wyman analysis).

3 The underserved financial services market includes both alternative and mainstream products and services, including auto loans, payday loans, check cashing, and other credit, payment, and deposit products. See Wolkowitz, E. "2013 Financially Underserved Market Size." Center for Financial Services Innovation. 2014. Web. www.cfsinnovation.com/Document-Library/2013-Financially-Underserved-Market-Size.

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9 Mullainathan & Shafir, 2013; Shah, Shafir, & Mullainathan, 2015.

Note For a complete list of sources and methodologies, please see the full report at oliverwyman.com or ideas42.org

ABOUT OLIVER WYMAN

Oliver Wyman is a global leader in management consulting. With offices in 50+ cities across 26 countries, Oliver Wyman combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation. The firm's 3,700 professionals help clients optimize their business, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities. Oliver Wyman is a wholly owned subsidiary of Marsh & McLennan Companies [NYSE: MMC], a global team of professional services companies offering clients advice and solutions in the areas of risk, strategy and human capital. With over 57,000 employees worldwide and annual revenue exceeding $13 billion, Marsh & McLennan Companies is also the parent company of Marsh, a global leader in insurance broking and risk management; Guy Carpenter, a global leader in providing risk and reinsurance intermediary services; and Mercer, a global leader in talent, health, retirement and investment consulting. For more information, visit www.oliverwyman.com. Follow Oliver Wyman on Twitter @OliverWyman.

ABOUT IDEAS42

ideas42 is a non-profit organization that uses insights from behavioral science – which helps us understand the choices and decisions people make – to design innovative solutions to tough social problems at scale. The consequences of the behavioral issues we tackle are often profound. All too frequently, the reasons for these failures turn out to be small and remediable, but they are usually overlooked or dismissed as unimportant. We work, therefore, to identify subtle but important contextual details that can have a disproportionate impact on outcomes. We work in a number of areas: consumer finance, economic mobility, health, education, criminal justice, energy efficiency, and international development. Our work involves a lot of observation, a deep understanding of behavioral science, plenty of patience, and a willingness to be surprised.