

Consumer & Community Context

A series examining economic and financial topics affecting consumers and communities

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Two Tales of Changes in Retail Banking

Technological innovations have transformed the ways in which banks and consumers interact. For some consumers, these innovations have brought many conveniences, such as the ability to check account balances and deposit checks from their mobile phones. However, these innovations have also contributed to the closure of many traditional brick-and-mortar bank branches. For those who still rely on the services of branches, closures can be disruptive and harmful. For example, a recent Federal Reserve Board report, *Perspectives from Main Street: Bank Branch Access in Rural Communities*, found that consumers in affected communities reported “increased costs and reduced convenience in accessing financial services.”¹

The pace of change in retail banking is rapid and raises important questions about the impacts on consumers and communities. For example, will these innovations lead to a more inclusive financial sector, or will they leave behind underserved consumers? Is online banking an option for consumers and small businesses when banks close branches?

This issue of *Consumer & Community Context* focuses on two aspects of these changes in retail banking. The [first article](#) examines the implications of faster payments for cash-flow-constrained consumers. The [second article](#) explores the emergence of online-only subsidiaries of traditional brick-and-mortar banks.

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Note: Alejandra Lopez-Fernandini and PJ Tabit of the Federal Reserve Board’s Division of Consumer and Community Affairs contributed to this introduction.

1. See <https://www.federalreserve.gov/publications/november-2019-bank-branch-access-in-rural-communities.htm>.

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Delivering Benefits of Faster Payments to the Underserved

by Claire Greene, Federal Reserve Bank of Atlanta Risk and Compliance Division; Fumiko Hayashi, Federal Reserve Bank of Kansas City Economic Research Division; and Joanna Stavins, Federal Reserve Bank of Boston Research Department¹

Faster payments may assist cash-strapped consumers with several factors influencing how broadly the benefits are shared.

On August 5, 2019, the Federal Reserve announced its decision to develop the FedNowSM Service, a new service that is intended to allow banks to settle payments in real time 24x7x365, which in turn would allow their customers to send funds quickly and use received funds almost instantly. The Clearing House, an industry-owned banking association and payments company, launched a similar service in November 2017.²

For cash-strapped consumers, the ability to both send and receive payments almost instantly at any time may help mitigate misalignments between the time that incoming funds are received and the time that payments need to occur. This improved speed would potentially allow consumers to avoid high-cost credit products and penalties, such as payday loans and overdraft and late fees.

Whether the benefits of faster payments will be realized by cash-flow-constrained consumers, however, depends on the services offered by banks and nonbank account service providers (such as general-purpose reloadable prepaid card providers).³ Compared with fully banked consumers, additional steps may be required for unbanked and underbanked consumers (hereafter collectively called “underserved”) to realize the benefits of faster payments.⁴ For

1. Ellen Merry, Board of Governors of the Federal Reserve System, provided valuable guidance and analysis for this article. Liang Zhang, Federal Reserve Bank of Boston, and Sabrina Minhas, a former research associate at the Federal Reserve Bank of Kansas City, provided excellent research assistance. Larry Bean provided diligent editing. The authors are responsible for any errors.

2. The infrastructure of both The Clearing House’s Real-Time Payments network and the Fed-Now Service will enable banks and, through their relationships with banks, nonbank account service providers to offer faster payments to their customers, providing various types of retail banking services without incurring the risk of not receiving funds from the payers’ banks.

3. Today, general-purpose reloadable prepaid cards generally allow consumers to receive direct deposits using the automated clearinghouse system.

4. *Unbanked households* means that no one in the household has a checking or savings account at an institution insured by the Federal Deposit Insurance Corporation (FDIC). *Underbanked consumers* are defined as those who have a bank account but used at least one of the following alternative financial services from an alternative provider in the past 12 months: money orders, check cashing, international remittances, payday loans, refund anticipation loans, rent-to-

instance, unbanked consumers may need to open a checking or prepaid card account to send and receive faster payments. Furthermore, if the payers of funds (such as employers currently paying their employees by paper checks) do not adopt faster payments, receivers of payments, including cash-flow-constrained consumers, would not realize full benefits.

In this article, we identify instances where cash-flow-constrained consumers are most likely to benefit from faster payments. We also describe factors that could influence the benefits to these consumers. We finish by highlighting opportunities for financial institutions, consumer educators, and policymakers to ensure that the benefits of faster payments are broadly felt.

[Twenty] percent of consumers with a bank account overdrew it in the preceding 12 months, and 70 percent of this group paid overdraft fees.

Underbanked Consumers with Volatile Income Encounter Difficulty Accessing Money Quickly from Their Bank Accounts

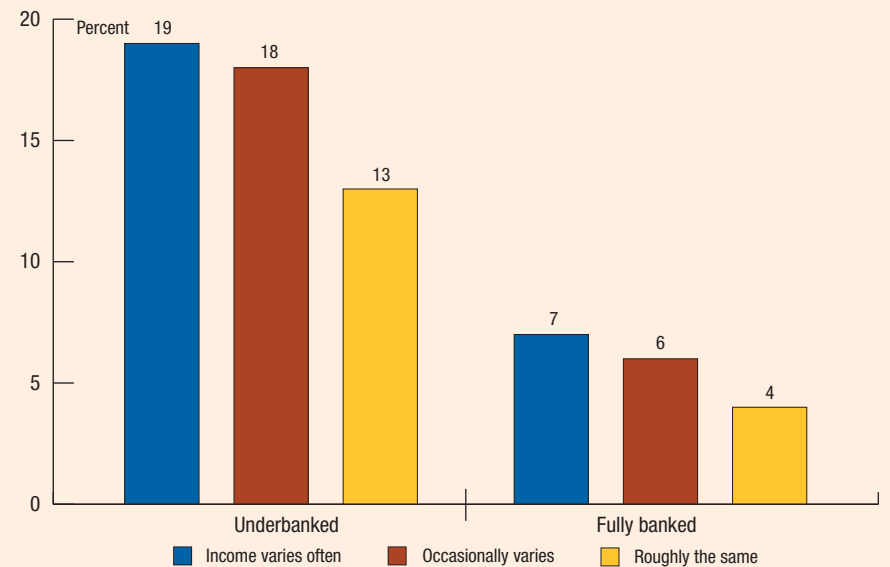
Banking status and income volatility are both correlated with having problems accessing funds in bank accounts due to delays in when the money could be used. According to the Federal Reserve Board's *2018 Survey of Household Economics and Decisionmaking* (SHED) data, among consumers with a bank account, 17 percent were underbanked. Of those, 15 percent had problems accessing funds. In comparison, only 5 percent of fully banked consumers had such problems.⁵ Also according to the SHED data, 28 percent of all consumers had volatile income in 2018, with 35 percent of underbanked consumers having volatile income. Among the underbanked, those consumers whose income varied often or occasionally were more likely to have trouble accessing funds than consumers with roughly steady income (figure 1).

Since faster payments would allow consumers to have access to their funds more quickly, they could potentially reduce the shares of consumers who face such challenges.

own services, pawnshop loans, or auto title loans. See Federal Deposit Insurance Corporation, *2017 FDIC National Survey of Unbanked and Underbanked Households* (Washington: FDIC, October 2018), <https://www.fdic.gov/householdsurvey/>.

5. Board of Governors of the Federal Reserve System, *2018 Survey of Household Economics and Decisionmaking Data*, https://www.federalreserve.gov/consumerscommunities/shed_data.htm.

Figure 1. Had problem accessing funds due to delay in when money could be used



Note: The sample includes 10,646 consumers with a bank account. Key identifies bars in order from left to right.

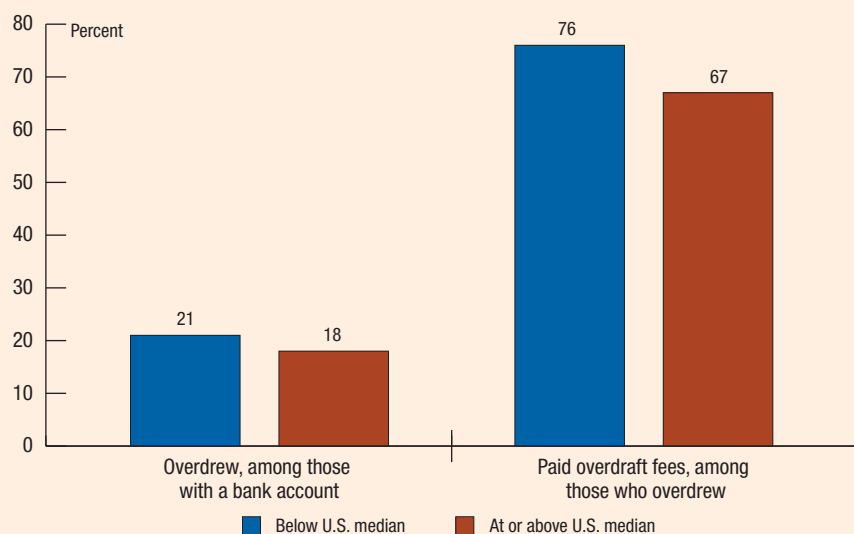
Source: The authors' calculation based on 2018 Survey of Household Economics and Decisionmaking data.

Lower-Income Consumers Are More Likely to Incur Fees for Overdrawing and Paying Bills Late

Slow and/or unpredictable receipt of payments into their bank accounts may contribute to consumers incurring fees for overdrawing their bank accounts and paying bills late. Using the Federal Reserve Bank of Atlanta’s 2018 *Survey of Consumer Payment Choice* (SCPC) data, we find that 20 percent of consumers with a bank account overdraw it in the preceding 12 months, and 70 percent of this group paid overdraft fees.⁶ We also find that income is only slightly correlated with overdrawing, but among those who do overdraw, income is more strongly negatively correlated with being charged a fee for doing so.⁷ The share of consumers who overdraw their bank account among those with household income below the U.S. median (\$63,179 in 2018) is slightly greater than that among those with household income at or above the U.S. median (21 percent versus 18 percent) (figure 2). But given that a consumer has

6. See Kevin Foster, Claire Greene, and Joanna Stavins, *2018 Survey of Consumer Payment Choice* (Atlanta: Federal Reserve Bank of Atlanta, August 2019), <https://www.frbatlanta.org/banking-and-payments/consumer-payments/survey-of-consumer-payment-choice>.

7. SCPC data indicate that consumers with household incomes below the U.S. median are less likely to have overdraft protection.

Figure 2. Overdraft experience by household income

Note: The sample includes 2,936 consumers with a bank account. Key identifies bars in order from left to right.

Source: The authors' calculation based on 2018 Survey of Consumer Payment Choice data.

overdrawn, 76 percent of those with income below the U.S. median paid overdraft fees—almost 10 percentage points more than consumers with income at or above the U.S. median.

Low-income consumers are also more likely to pay bills late and incur late fees charged by billers. Using the Federal Reserve Bank of Atlanta's *2018 Diary of Consumer Payment Choice* data, we calculate the shares of bills that were paid late and that incurred late fees by income group.⁸ Among bills paid by consumers with household income below \$25,000, 17 percent of them were late and 5 percent incurred late fees. In contrast, among bills paid by consumers with household income above \$100,000, 10 percent were late and 2 percent incurred late fees.

Faster payments could potentially help both low- and high-income consumers avoid overdraft and late fees if they enable consumers to pay bills at the last minute and receive income to pay such bills more quickly.

8. Claire Greene and Joanna Stavins, *2018 Diary of Consumer Payment Choice* (Atlanta: Federal Reserve Bank of Atlanta, December 2019), <https://www.frbatlanta.org/banking-and-payments/consumer-payments/diary-of-consumer-payment-choice>.

Faster payments could benefit cash-flow-constrained consumers who are often underbanked, have volatile incomes, are low-income, and/or rely on costly alternative financial services.

Timing Problems Could Be Making Some Consumers Use High-Cost Alternative Financial Services

To address a misalignment of the timing between incoming funds and spending needs, underbanked consumers and some unbanked consumers might use alternative financial services, such as check-cashing services and payday loans. Nonbanks' check-cashing services enable consumers to access the full amount of their income quickly.⁹ Payday loans allow consumers to borrow small amounts to pay bills that come due before their income is available.¹⁰ These services, however, are typically very expensive. Although many states cap check-cashing fees, the fee cap varies by state, ranging from 1 to 12 percent of the check amount.¹¹ According to the Center for Responsible Lending, the national average annual interest rate of payday loans is almost 400 percent.¹² Despite their high costs, according to the *2017 FDIC National Survey of Unbanked and Underbanked Households*, 27 percent of unbanked and 22 percent of underbanked households used check-cashing services, and 3 percent of unbanked and 8 percent of underbanked households used payday loans in 2017.

If faster payments resolve some of the timing issues consumers face, they may avoid incurring the high costs associated with alternative financial services and increase their engagement with the banking system.

Various Factors May Influence Whether Faster Payments Benefit Everyone Equally

As already noted, faster payments could benefit cash-flow-constrained consumers who are often underbanked, have volatile incomes, are low-income, and/or rely on costly alternative financial services. However, several factors could influence whether these individuals enjoy the benefits of faster payments. These include the following:

9. Rachel Schneider and Balafama Longjohn, *Beyond Check-Cashing: An Examination of Consumer Demand and Business Innovation for Immediate Access to Check Funds* (Chicago: Center for Financial Services Innovation, June 2014), http://cfsinnovation.s3.amazonaws.com/RESEARCH_FIS_CFSI_BeyondCheckCashing_6.3.2014_FINAL.pdf.

10. Nicholas Bianchi and Rob Levy, *Know Your Borrower: The Four Need Cases of Small-Dollar Credit Consumers* (Chicago: Center for Financial Services Innovation, December 2013), <https://s3.amazonaws.com/cfsi-innovation-files/wp-content/uploads/2017/01/26054909/Know-Your-Borrower-The-Four-Need-Cases-of-Small-Dollar-Credit-Consumers.pdf>.

11. See Financial Service Centers of America, Inc. "Summary of State Check Cashing Laws—Updated August 2013," (2013), <https://www.natcnc.com/wp-content/uploads/2016/10/FISCA-State-CC-Laws-2013.pdf>.

12. See "Map of U.S. Payday Interest Rates," February 14, 2019, <https://www.responsiblelending.org/research-publication/map-us-payday-interest-rates>.

- **Unbanked consumers are less likely to use the payment instruments that will incorporate faster payments.** Unbanked households tend to use cash and nonbank money orders to pay bills. Although general-purpose reloadable prepaid cards may possibly allow consumers to send and receive faster payments in the future, only 27 percent of unbanked households used such cards in 2017.¹³ Unbanked households also have limited access to the internet or a smartphone, which may prevent them from enjoying a key benefit of faster payments: 24x7x365 availability.¹⁴ Bringing these consumers into a new payments system may require facilitating access to payment instruments that can incorporate faster payments.
- **Many underserved consumers receive income by paper check.** Relative to fully banked households, underserved households are more likely to receive income via paper check.¹⁵ For those consumers to receive their funds with the immediacy provided by faster payments, payers of income payments, such as employers, need to adopt faster payments.
- **The level and predictability of fees have not yet been established.** If consumers perceive that fees charged for faster payments are unpredictable or high relative to the benefit of faster payments, they may not use faster payments. About 27 percent of unbanked households, in particular, cited high fees and/or unpredictable fees as a reason for avoiding the banking system.¹⁶
- **Consumer liability for authorized yet erroneous payments may vary by bank.** Under the current consumer protection regulations, banks are not required to reimburse consumers when a legitimate account-holding consumer initiates a push payment—for which the payer instructs their bank to push funds to the recipient's bank—to a wrong recipient due to the consumer's falling for a scam or making an error. As a result, some banks may reimburse consumers, and other banks may not do the same. Varying banks' treatment of consumers' erroneous push payments could make consumers, especially vulnerable consumers, uncertain about the risk of such payments, potentially discouraging them from using faster payments.¹⁷

13. Federal Deposit Insurance Corporation, *2017 FDIC National Survey*.

14. Based on the *2017 FDIC National Survey* data, 55 percent of unbanked households have access to the internet or a smartphone, compared to 87 percent of fully banked households.

15. Based on the *2017 FDIC National Survey* data, 32 percent of the unbanked and 30 percent of the underbanked receive their income via paper check, compared with 24 percent of the fully banked.

16. Federal Deposit Insurance Corporation, *2017 FDIC National Survey*.

17. Unlike card or check payments for which the payer authorizes the recipient (and the recipient's bank) to pull funds from the payer's bank, faster payments (and wire payments) are push payments. In addition, the funds for faster payments (and wire payments) are settled rapidly and irrevocably between the payer's and recipient's banks. Because of these differences, resolution of con-

As firms begin to offer [faster payment services], it is important that [service providers] consider ways to ensure that the benefits of faster payments extend broadly to U.S. consumers.

Opportunities for Payments Providers, Consumer Educators, and Policymakers

Since faster payments are still at an early stage, many banks and nonbank account service providers have yet to offer faster payments services. As firms begin to offer these services, it is important that they consider ways to ensure that the benefits of faster payments extend broadly to U.S. consumers. To this end, features of faster payment services could include a mobile channel to access faster payments, transparent and easy-to-understand fees, and full disclosure of consumer liability and protections. The clarity around fees and consumer protections may help protect all consumers, but could be particularly important for the underserved who lack access to traditional financial services and may be more sensitive to fees.

Other stakeholders may also play important roles. Consumer education may be needed to inform consumers of the benefits and risks of using faster payments. Regulators' roles may include ensuring that faster payments services generate benefits for consumers, especially underserved consumers. Policymakers could facilitate the adoption of the services by coordinating the provision of consumer education and disclosures so that all consumers, including the underserved, can clearly understand the benefits and risks before using faster payments.

sumers' erroneous payments provided by banks associated with faster payments could be different from those associated with card and check payments.

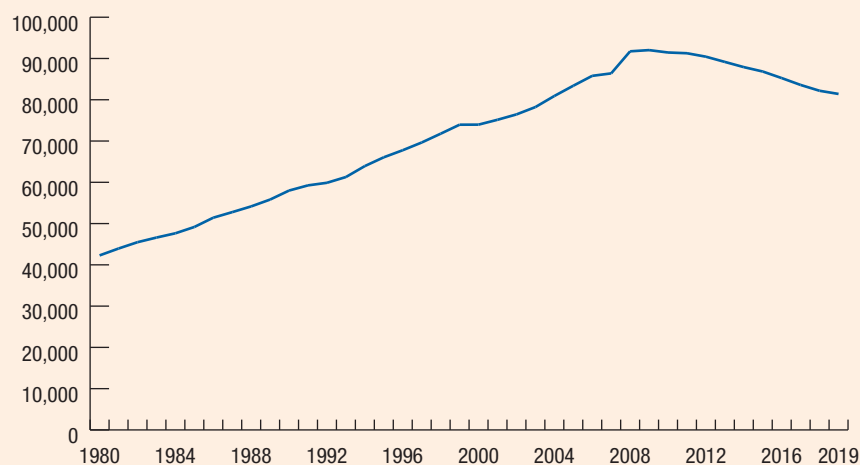
A Survey of Separately Branded Online-Only Banks and Their Role in the Banking System

Neil Wiggins, Supervision Division, Federal Reserve Bank of St. Louis, and Dasha Basnakian, Research Division, Federal Reserve Bank of Atlanta

Separately branded online-only banks are uncommon, but may benefit some consumers.

Technological innovation has had a widespread impact on numerous facets of everyday life, and banking has been no exception. The emergence of online and mobile banking are, perhaps, the most prominent examples of technological innovation in banking. Most of today's banks provide a standard suite of online and mobile banking tools that allow customers convenient access to traditional banking services. Customers' wide acceptance of these tools likely has contributed to reduced traffic at branch locations and to the 11 percent reduction in the number of bank branches in the U.S. since 2009 (see [figure 1](#)).¹

Figure 1. Number of bank and thrift branches in the U.S.



Source: National Information Center (NIC).

The high adoption and acceptance rate of mobile and online banking has also led to a rapid pace of innovation. One of those new innovations is the development of online-only subsidiaries of traditional brick-and-mortar banks,

1. Federal Deposit Insurance Corporation (FDIC), Summary of Deposits data, June 30, 2007, and June 30, 2019.

Some banks have chosen to strategically develop a separately branded online-only bank in an effort to expand the availability of their financial services well beyond the reach of their existing brick-and-mortar branch networks.

also called separately branded online-only banks (SBOBs). This article aims to take a deeper look at these SBOBs.

While today's online and mobile banking services provide convenient access to traditional banking, some banks have chosen to strategically develop an SBOB in an effort to expand the availability of their financial services well beyond the reach of their existing brick-and-mortar branch networks. An SBOB is not a new bank, but rather a division or affiliate of an existing bank. This online platform allows a bank to offer specialized loan or deposit products through an online-only platform to reach particular audiences outside of its existing markets without the costs of a traditional branch network. In addition, an SBOB may be a good place to try out new online banking products or services without alienating the bank's broader customer base.

In this article, we identify SBOBs from bank regulatory reporting data and analyze their products and services. Then, we place them into one of three categories based on their primary functions and describe how the features of these banks compare to traditional brick-and-mortar banks. And finally, we consider how these banks may impact consumers and communities.

Overview of SBOBs

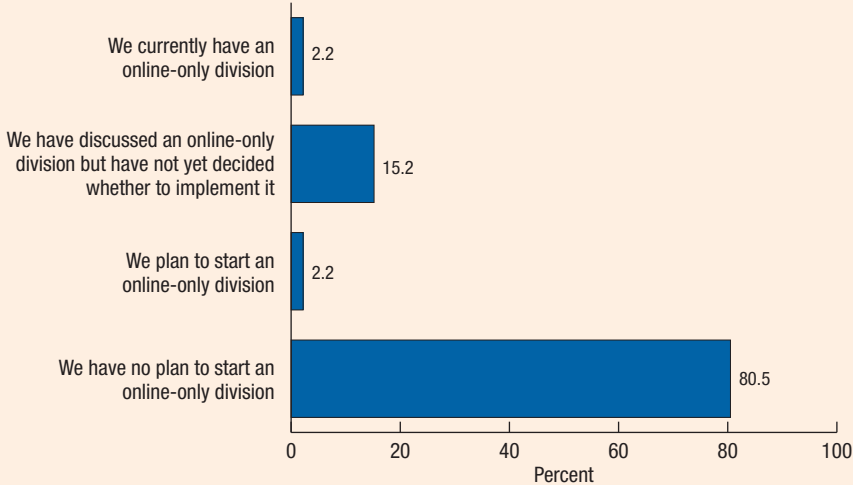
Right now, SBOBs are rare. According to our analysis of reports that banks submitted to federal financial regulators, as of June 2019 only 40 banks (less than 1 percent of domestic banks) have established an SBOB.² However, we have some evidence that SBOBs are poised to become more common. According to the 2019 Conference of State Bank Supervisors National Survey of Community Banks, about 15 percent of respondents (see [figure 2](#)) have discussed opening an online-only subsidiary.³

Based on the products and services described on the SBOBs' websites, we placed them into one of three categories according to their primary functions:

2. This estimate is based on our analysis of the June 30, 2019, Consolidated Reports of Condition and Income (Call Report). We created a subset of banks that reported data in the "URLs of all other public-facing internet websites that the reporting institution uses to accept or solicit deposits" field. From that subset of banks, we narrowed the list further by excluding URLs of brokerage sites, social media sites, and retained URLs from mergers.

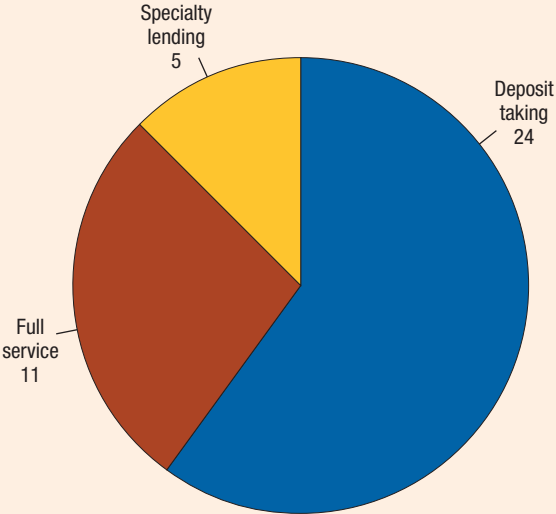
3. Figure 2 originally appears in the *Community Banking in the 21st Century 2019* Research and Policy Conference publication sponsored by the Federal Reserve System, Conference of State Bank Supervisors, and the FDIC, and is used with permission; see "Figure 21. Which of the Following Best Describes Your Views on the Creation of a Separately Branded Online-Only Division (i.e., a Microbank) to Attract Loans and/or Deposits?" at https://www.communitybanking.org/~media/files/publication/cb21publication_2019.pdf.

Figure 2. Which of the following best describes your views on the creation of a separately branded online-only division (i.e., a microbank) to attract loans and/or deposits?



full-service banking, deposit taking, and specialty lending. (Figure 3 shows the number of SBOBs in each category). The groups are designed to be broad categorizations and do not account for the nuances of each individual bank’s SBOB.

Figure 3. Number of SBOBs, by type



Note: As of June 2019.
Source: Based on author analysis of National Information Center data.

Types of SBOBs

Full Service

Full-service SBOBs are most similar to traditional brick-and-mortar banks. These SBOBs appear to offer all the benefits of a traditional bank without requiring customers to step foot inside a physical location or directly interact with bank employees. Although this experience may not be for everyone, a growing number of customers of even brick-and-mortar banks are handling their banking needs this way via mobile and online services. A brick-and-mortar bank offering a full-service SBOB is likely to benefit from a much larger geographic reach with little additional overhead. From our analysis, the full-service SBOBs do not appear to offer higher interest rates on deposits (see table 1).⁴

Table 1. Interest rate offerings among SBOBs versus affiliated banks

SBOB type	SBOB rate range	SBOB median rate	Affiliated bank rate range	Affiliated bank median rate
Full service	0.45 to 2.00	1.40	0.45 to 2.05	1.36
Deposit taking	1.00 to 2.25	1.90	0.75 to 2.36	1.75
Specialty lending	n.d.	n.d.	n.d.	n.d.

Note: n.d. indicates no data available. Rates are expressed as APY.

Source: Author survey of SBOB and affiliated bank websites, November 2019.

This type of SBOB may offer a convenient and accessible alternative bank for customers with limited local banking options; however, full-service SBOBs may not overcome the biggest obstacles facing individuals who are currently underbanked or unbanked. According to the *2017 FDIC National Survey of Unbanked and Underbanked Households*, the most common reasons for households to be unbanked were that they do not have enough money to keep in an account; don't trust banks; think bank account fees are too high; or think that bank account fees are unpredictable.⁵ A bank account that is only accessible online does not directly address any of these issues.

As for customer service, although the full-service SBOBs do provide help and FAQ pages on their websites, most account fees are not presented up front, and

4. Our analysis does not include internet-only banks that are not subsidiaries of brick-and-mortar banks.

5. Federal Deposit Insurance Corporation, *2017 National Survey of Unbanked and Underbanked Households* (Washington: FDIC, October 2018), <https://www.fdic.gov/householdsurvey/2017/2017report.pdf>.

we found inconsistent information on ATM access. Additionally, the FDIC survey reported that while mobile banking is the most common way for banked customers to access their accounts, the use of bank tellers remains common, particularly among unbanked and underbanked populations.

Deposit Taking

SBOBs established with the primary purpose of deposit taking generally offer high-yield savings accounts and CDs via the internet with interest rate offerings routinely in excess of market averages (see table 1). The high-yield accounts may in some cases include specific provisions, such as dormant account fees or sizable minimum balances. For example, at the time of writing, one brick-and-mortar bank with an online subsidiary reported its high-yield savings account earns up to 1.3 percent annual percentage yield (APY). Meanwhile, its SBOB advertises 2.0 percent APY on high-yield savings accounts with at least \$10,000 deposited.⁶ These accounts, like those of traditional banks, provide FDIC insurance that protects depositors against losses up to at least \$250,000 per account. New customers open accounts online and fund their new account from an existing bank account.

Because these accounts must be funded with an existing bank account and have a minimum balance before earning interest, these offerings appear to cater to clients who have an existing banking relationship and at least a moderate level of savings. As a result, they may not benefit individuals with limited engagement in the financial system, such as the unbanked and underbanked or low- and moderate-income individuals.

It's also unclear what effect SBOBs have on deposit gathering in a community. Currently, regulators do not have bank- or branch-level data on deposit origination. Thus, deposits collected from an SBOB are rolled into the primary bank's balance sheet and reported on the FDIC Summary of Deposits survey as consolidated deposits or as deposits of cyberbranches. Without this key piece of information, we are unable to see how or if the deposits are invested back into the community from which they were gathered.

Specialty Lending

SBOBs in the specialty lending category offer very narrow-scope lending. For example, SBOBs offer unique loan products to buy RVs, boats, vacation homes,

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6. Accounts under \$10,000 do not earn interest.

Continued research on the declining number of branches and access to banking services . . . can help shed light on alternatives available to residents in communities where traditional branches close.

and timeshares. Our analysis shows that these SBOBs don't offer any "traditional" banking services, such as checking or savings accounts, and it was unclear whether the SBOB's parent bank would offer loans for the same types of purchases.

It is difficult to measure the benefits of a specialized lender to the communities in which it operates due to the small number of participants and the limited data on loan portfolios. Additionally, loans for RVs and boats are marketed toward individuals with higher levels of disposable income, and the limited services offered on the sites we visited for this type of SBOB would not offer any new opportunities to obtain banking services for individuals who are currently underbanked or unbanked.

Further Research and Considerations

Although the SBOB is a new concept, we believe regulators should continue to monitor these types of banks. As mentioned earlier, bankers are discussing opening SBOBs, and regulators should be on the forefront of identifying risks to the banks that operate them. Regulators should also consider whether additional data are needed to track whether a bank's deposits originate from its brick-and-mortar network or from its SBOB affiliate. Finally, regulators should review whether SBOB deposits draw funds away from local communities.

Additionally, continued research on the declining number of branches and access to banking services, as well as innovation from traditional brick-and-mortar banks to bring more financial products and services online, can help shed light on alternatives available to residents in communities where traditional branches close.

Conclusion

As banks increasingly turn to SBOBs, it may offer a glimpse into the next wave of innovation in banking. After taking a closer look at the current landscape, we found that very few banks have opened this type of online bank, and that, at this time, SBOBs may not offer viable banking solutions to the underbanked or unbanked. As with any new financial technology, regulators should be looking at the product and considering the impact on the institution and the customer.

