AB 1177: CALIFORNIA BANKING OPTION ACT

Creating Universal Access to Bank Accounts with BankCal

Report Highlights

- BankCal can be self-sustaining within 5 years
- BankCal can draw on existing state programs to reach a customer base of millions of Californians
- In 5 years BankCal could save households $460 million, producing $638 million in economic activity
- Latinx and Black households will benefit the most with savings accounting for more than 4 percent of household income

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MAY 2021

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EXECUTIVE SUMMARY

<5 Years

TO A SELF-SUSTAINING BANKCAL PROGRAM

$460M

ANNUAL SAVINGS FOR THE NEEDIEST CALIFORNIANS

$638M

TOTAL ANNUAL ECONOMIC IMPACT WITHIN 5 YEARS

BankCal is highly likely to become self-sustaining within 5 years, particularly if the state takes advantage of its unique channels to acquire customers and negotiate with vendors. Reaching breakeven for the program has a potentially large economic impact for California.

Lack of access to banking creates several challenges that warrant public action. Financial exclusion creates vulnerability, allows for exploitation by predatory lenders, harms local economies, and exacerbates racial, gender, and ethnic disparities.

These challenges are not addressed by existing programs. Existing programs to expand financial inclusion have low bank participation, high account closures, and do not target the populations most in need.

BankCal, a public retail banking option, is on a spectrum of potential public actions. Public actions range from regulating the private sector to creating an entirely public bank. The program being proposed in AB1177, BankCal, offers a middle ground public option for retail banking.

There are multiple pathways for BankCal to become self-sustaining within 5 years. We define program sustainability as the breakeven point when revenue equals operating costs. Sustainability depends on customer growth, the level of interchange fees it receives, and the costs incurred by BankCal of customers accessing ATMs. HR&A modelled three potential pathways that all break even to become cashflow positive in 5 years.

Becoming self-sustaining will require California to take several key actions. The state should leverage existing channels to boost participation. It will also be important to ensure low costs by running a competitive RFP process for service providers and vendors. Finally, California can leverage the Community Reinvestment Act to make sure that BankCal can provide ATM network access at low or no costs to itself.

Within 5 years, a self-sufficient BankCal will have large household and economic benefits. With fewer or no bank fees to pay, households will have more disposable income to spend in their local economy. California households would save $460 million, potentially generating a total local economic impact of $638 million.

HOW EXISTING SERVICES FAIL CALIFORNIANS

UNBANKED HOUSEHOLDS' CONCERNS INCLUDE FEES, COSTS, AND MISTRUST

According to a 2019 FDIC survey of unbanked households, the top reason Californians are unbanked is due to a **lack of funds to cover a minimum balance requirement.** Approximately half of unbanked households noted this a reason for being unbanked. Of note, this percentage is down from a high of 68 percent in 2017.

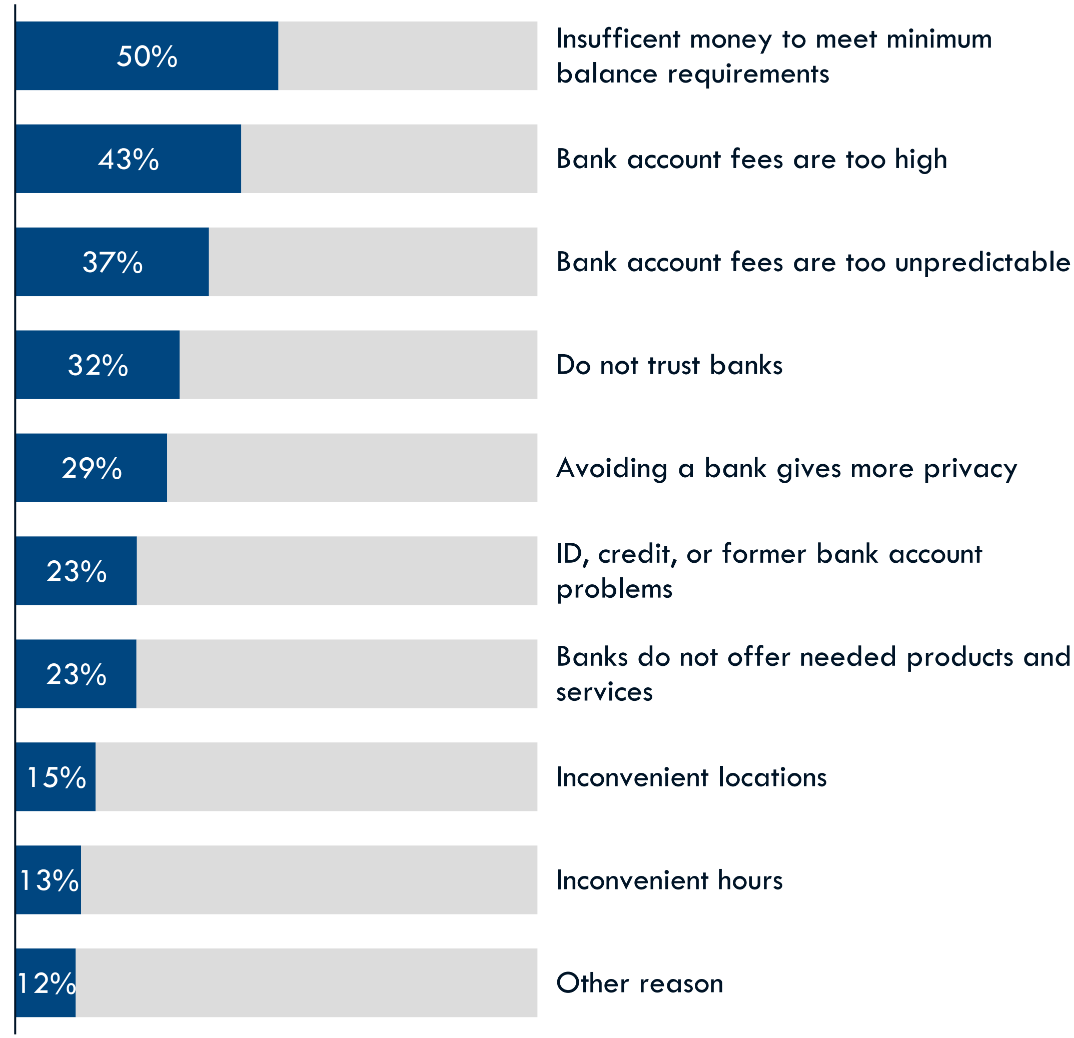
Another highly noted reason is **bank account fees.** 43 percent of respondents said bank fees are too high and 37 percent said they were too unpredictable.

A significant share, 32 percent, of survey respondents also noted **lack of trust in banks.**

A smaller share of respondents, 15 percent, noted **inconvenient locations** and 13 percent noted **inconvenient hours.**

These relative rankings give an indication that **new solutions are needed meet the challenge of equalizing banking access.**

Reason an Individual in California is Unbanked (2019)



Source: FDIC

TRADITIONAL PRIVATE BANK PROGRAMS DO NOT FILL THE GAP

There are existing options for very low- to no-fee bank accounts but barriers remain with the private banking model. One nonprofit initiative, Bank On, set out to improve service offerings by certifying banks that offer free checking accounts in compliance with their standards. Bank On's work in Los Angeles, San Francisco and Sacramento has shown how much pent-up demand there is for lower-cost bank accounts. However, several structural issues remain in the banking sector:

1. **Misaligned incentives:** Private banks' financial incentive for opening new accounts with the unbanked customer relies on fees rather than income from holding large deposits. Fees, particularly overdraft fees, are a major source of income for private banks but can drain low balance customer's fees. According to the Center for Responsible Lending, in 2019 big banks made $11 billion in overdraft fees that were paid by just 9 percent of customers whose balances average less than $350.

2. **Limited participation from banks & credit unions**: Only three of 63 banks and three of 48 credit unions offer accounts with no monthly fee in Los Angeles despite efforts by the county and Bank On. These banks are still charging fees including overdraft fees.

3. **Program commitment**: According to data from the St Louis Federal Reserve, just 60 percent of the 657,000 Bank On certified accounts remained open after two years. Given misaligned incentives, participating banks appear to have made a limited commitment to expanding or maintaining Bank On accounts.

PROVIDING UNIVERSAL ACCESS TO BANK ACCOUNTS WILL REQUIRE NEW PUBLIC SOLUTIONS

Overcoming the persistent inequality in banking services in California will require new approaches. The traditional formal banking system has not provided access to the unbanked because these accounts offer small and inconsistent profit margins, despite high returns on overdraft fees. Recent innovations in technology are driving down the costs of providing basic banking services by unbundling physical access from financial access. Yet millions of Californians still lack access.

The public sector must be part of the solution to guarantee universal access. There is a spectrum of options for public sector involvement. The least involvement would be increasing regulations or direct incentives to formal banks to provide bank accounts. The highest level of involvement would be a full public bank that can offer a full suite of services. A middle ground would be a public option that offers a stable, affordable financial platform. The public option would complement other existing public financial services programs.

Spectrum of Public Support for Banking

BANKCAL IS A PUBLIC PLATFORM THAT CALIFORNIANS CAN TRUST

BankCal, creates a public retail option that would offer every Californian:

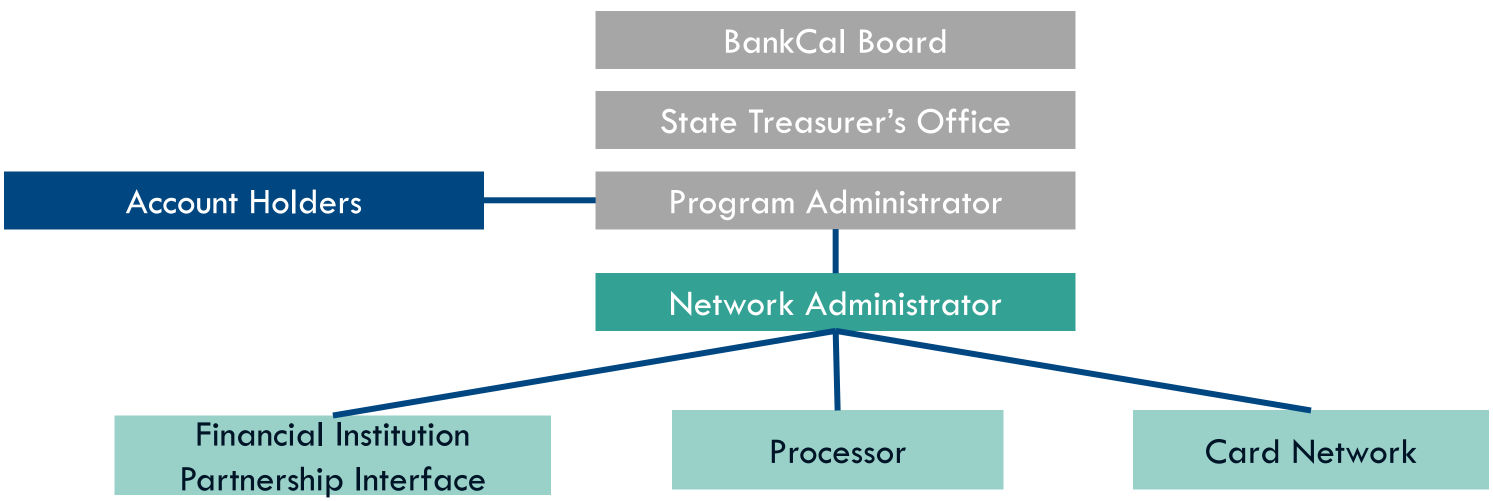
A zero-fee, zero-penalty debit (checking) account and debit card

Direct deposit from employers and public benefits providers

Automatic bill pay to registered payees

Integration with the existing network of public programs

BankCal will exist within the State Treasurer's Office, like other financial service programs, and be administrated by a Program Administrator and Network Administrator.



HOW BANKCAL CAN BECOME FINANCIALLY SELF-SUSTAINING

METHODOLOGY

HR&A built a cash flow model to examine the impact of changes in major revenue and cost sources. We derived the structure and parameters for our model from background materials on BankCal, conversations with program advocates and industry experts, and independent research of public banking data (e.g., Federal Reserve reports) and industry comparables. For full details on our sources, see page 17.

Our model includes both fixed and variable costs necessary to operate BankCal. The largest operating costs are for the Network Administrator and Program Administrator. Industry experts at a financial technology (fintech) company estimated Network Administrator costs of $2.50 million per quarter and the State Treasurer's Office estimated Program Administrator costs of $1.25 million per quarter. We also included a fixed $5.00 fee to issue each debit card. ATM withdrawal fees are the other major cost but these vary widely based on terms negotiated with ATM networks or individual institutions. There is one main source of revenue, interchange fees, which is also variable based on negotiated terms.

Our model also includes assumptions about customers. Customer acquisition rates vary widely across the current industry. Therefore, our model also allows for wide variation in customer growth, starting from 10,000 customers in the first month. We also account for customers who are inactive or open and subsequently close their accounts.

Our model shows that proposed BankCal program can achieve financial sustainability in the short to medium term of 5 years or less and generate positive income thereafter. The key to achieving this outcome will be generating rapid customer growth that drives interchange revenue. It will also be critical to negotiate advantageous conditions with financial services providers. **We define program sustainability as the breakeven point when revenue equals operating costs.** Beyond achieving sustainability, our model suggests that if BankCal is set up with the proper structure it will generate positive income for the State and service providers.

THREE POTENTIAL PATHWAYS TO BECOMING SELF-SUSTAINING

We examined three scenarios where BankCal pays for itself depending on: customer growth rate, interchange fee level, and ATM withdrawal costs. All fixed costs stay the same across scenarios.

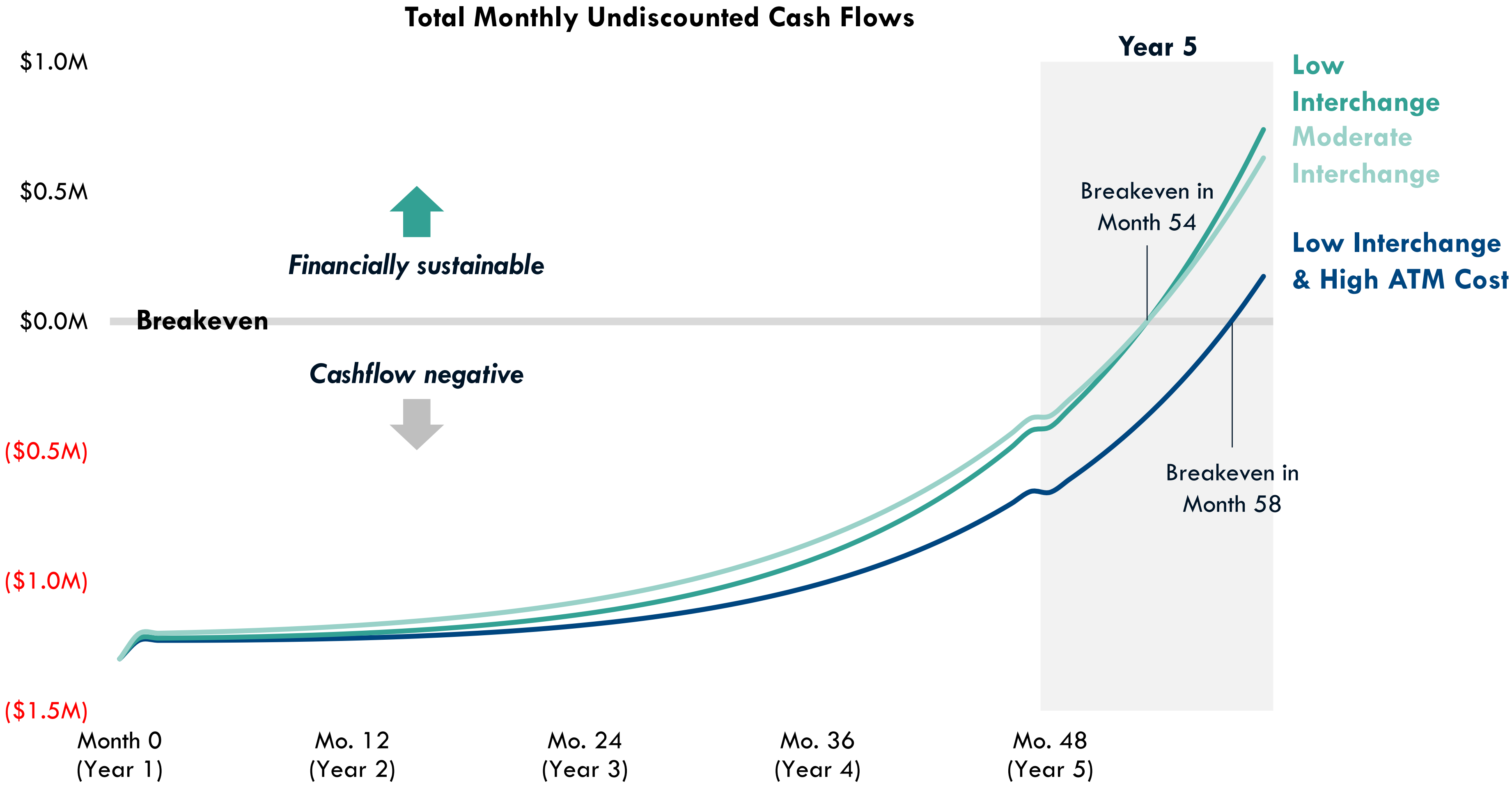
In the first scenario, we looked at low interchange fees and ATM costs. In this scenario, BankCal breaks even in month 58 with 657,000 customers. In the second scenario, we kept interchange fees low but assumed no ATM costs. This scenario breaks even in month 54 with 492,000 customers. Our final scenario, which looked at moderate interchange fees, also breaks even in month 54 but with just 304,000 customers. Note that our low interchange fee assumption is cautious, and we expect that the program would earn closer to and potentially above the moderate fee.

SCENARIO	LOW INTERCHANGE & ATM COST	LOW INTERCHANGE & NO ATM	MODERATE INTERCHANGE & NO ATM
Breakeven Month	58	54	54
Total Customers			
At Breakeven Month	657K	492K	304K
At End of Year 5	705K	705K	415K
Net New Customers Required per year	141K	141K	83K
Variable Revenue			
Interchange Fee Per debit card purchase	0.78%	0.78%	1.18%
Variable Cost			
ATM Per in-network withdrawal	($1.03)	None	None

Source: HR&A model, SEIU, Bank On, Federal Reserve.

CUSTOMER GROWTH IS A KEY FACTOR TO BECOMING SELF-SUSTAINING

In all three scenarios, the most critical factor is customer growth. Faster customer growth in the Low Interchange scenario drives revenue more than higher interchange fees in the Moderate Interchange scenario. The customer growth rate in these scenarios is similar to those achieved by fintech start-ups. Similarly, in the scenario with low interchange and ATM costs, the higher variable cost is still overcome through customer acquisition to break even in Year 5.



Source: HR&A model. Note: The jumps in the lines represent shifts in debit card replacement costs at initiation and when cards begin to expire after 4 years.

BANKCAL CAN TAP INTO EXISTING USER BASE TO ACQUIRE CUSTOMERS

BankCal has a low-cost means of acquiring customers compared to traditional banks and fintech start-ups: the private bank market is competitive and has high customer acquisition costs ($200 per customer on average).

Leverage Trust Advantage

Trust in state government can support customer acquisition. Many retail banks have acquired a reputation for high fees and poor customer service. Startups are susceptible to bankruptcy or financial issues. While the state has faced criticism for its provision of services (e.g., unemployment benefits), its ability to offer universal programs with continuity distinguishes it from private competitors.

Focus on the Un/ Underbanked

Because many public services reach populations that are un/underbanked, they are ideal channels to drive user growth and reduce customer acquisition costs. These services include unemployment benefits, tax credits, nutrition assistance, and other social programs.

Take Advantage of State Payments

Customer acquisition is most direct where services involve the state making payments (e.g., tax rebates, benefits). New and planned programs (e.g., CalSavers, CalKids, universal basic income pilot programs) offer additional growth opportunities. This will enable BankCal to achieve low customer acquisition costs, which are high for profit-driven banks and could otherwise be prohibitive for a public banking option.

Use Local Networks

Localities and community organizations constitute other channels for customer acquisition via their own services and initiatives. These include county- or city-provided social or public services and financial empowerment workshops run by community-based organizations or labor unions.

STATE AND PUBLIC PROGRAMS SUPPORT CUSTOMER ACQUISITION WHILE ALSO SERVING OFTEN UNBANKED POPULATIONS

There are up to 20.9 million Californians who receive cash transfers from the state that could be matched with a BankCal account and another 7.5 million Californians who access or are involved in other state services and programs that BankCal could target and support.

ENTITY	SERVICES / PROGRAMS	PEOPLE REACHED
FINANCIAL SERVICE PROGRAMS		
CA Tax Rebate	• Californians eligible to receive tax rebate	11.0M
CalFresh	• Nutrition assistance	3.8M
CalEITC	• California Earned Income Tax Credit	3.7M
Unemployment	• Unemployment	2.1M
CalSavers, CalKids, CalGrant	• Retirement savings • Education savings and financing	0.3M
SUBTOTAL ACCOUNTS		**20.9M**
OTHER PROGRAMS		
Dept. of Motor Vehicles	• ID cards & driver's licenses • Vehicle registrations	6.9M
Criminal Justice System	• Californians in jails and prisons • Californians on parole and probation	0.6M
Community Organizations	• Public libraries • Financial empowerment orgs.	Varies
SUBTOTAL ACCOUNTS		**7.5M**
TOTAL ACCOUNTS	*Note: Some individuals are likely duplicated.*	**28.4M**

Source: AP News, CA Dept. of Motor Vehicles, CA Dept. of Social Services, CA Franchise Tax Board, CA Employment Development Dept., Prison Policy Initiative, CA State Treasurer

CAPTURING 4% OF EXISTING STATE SERVICE USERS CAN LEAD TO A SELF-SUSTAINING PROGRAM

Just 4 percent of Californians that are already state program users need to sign up for a BankCal account to generate enough customers to break even by the middle of Year 5. This scenario accounts for Californians using multiple state services and provides a buffer for customer attrition. Based on the target number of customers required to reach breakeven, BankCal would need to capture between 2 percent and 4 percent of the potential customer base to break even under moderate and low interchange fee assumptions, respectively.

ENTITY	USERS	MODERATE INTERCHANGE	LOW INTERCHANGE
Capture Rate		2.4%	3.9%
CA Tax Rebate	11.00M	262K	425K
Dept. of Motor Vehicles	6.85M	163K	265K
CalFresh	3.76M	90K	146K
CalEITC	3.75M	89K	145K
Employment Development Dept.	2.10M	50K	81K
Criminal Justice System	565K	13K	22K
CalSavers, CalKids, Cal Grant	317K	8K	12K
Community Organizations	-	-	-
SUBTOTAL	**28.35M**	**675K**	**1.10M**
25% Reduction for Shared Users		(169K)	(274K)
30% Customer Attrition		(203K)	(329K)
TOTAL		**304K**	**493K**

Source: HR&A model, Bank On. Note: While the criminal justice system is not a voluntary program like the others, providing financial services to incarcerated individuals and returning citizens could support their well-being and reintegration and reduce recidivism.

BANKCAL CAN REDUCE FEES THROUGH CONTRACTING & COMPLIANCE

BankCal will benefit from reaching favorable agreements with key service providers to increase its revenue and reduce or eliminate costs to itself and to its customers. The state will need to identify service providers (including the financial institution, card network, and processor; see p. 8) for the program through an RFP process. The state should use this process to identify partners that enable it to provide financial services at no cost to customers through a self-supporting program structure that maximizes revenues and minimizes costs. To achieve this, the state should leverage the program's public benefits and potential scale as well as state and federal regulations.

While profit-driven banks can use fees to cross-subsidize internal operations and improve services to customers, a no-fee bank will be feasible if it can use the program's public purpose, scale, and the state's distinct advantages to reduce its costs to the minimum. **As the first scenario demonstrates, factors like ATM costs or lower interchange fees delay financial sustainability and require more customers to break even.**

AREA	CHALLENGE	SOLUTION
Intermediaries	• The many intermediaries involved in providing infrastructure and services for a bank's operations take a cut (per account or transaction) that reduces revenue or increases costs.	• Program administrator and network administrator RFPs should be structured to select vendors with the best cost-quality ratio while incentivizing provider competition for reduced costs.
Fees	• Profit-driven banks increase revenue and cross-subsidize services through customer fees (e.g., cash deposit fees, ATM fees) that are undesirable for a no-cost public banking option.	• Vendors can be encouraged to reduce BankCal and customer costs while maximizing interchange revenue by using California and federal laws to compel banks to participate (e.g., the Community Reinvestment Act).

FINANCIAL SUSTAINABILITY MODELING METHODOLOGY: PARAMETERS AND SOURCES

PARAMETER	DESCRIPTION	SOURCE
Timeline	The timeline begins in Month 0, the first month that the program begins accepting customers.	HR&A
Net Customer Growth	Customer accounts represent existing accounts. While the model uses percentage growth rates, we express the number of net new customers required as a yearly amount on p. 11 for simplicity. Note that because of account closures and turnover BankCal will need to enroll more than those numbers to reach its target.	HR&A
Inflation	We inflate dollar values for revenues and costs by 1.8 percent annually.	Federal Reserve
Revenue		
Interchange Fee	Variable revenue. Interchange fees are collected by card networks and paid to the bank that issued the payment card. The fees are provided by the Federal Reserve as part of its 2019 Debit Card Interchange Fees and Routing report, which expresses fees as a percentage of the average debit card transaction value. We use the all-network average of 1.18 percent for exempt transactions as our high fee and the all-network, all-transaction average of 0.78 percent as our low fee. Card issuers with assets below $10B are exempt from the regulated interchange fee standard, allowing them to charge higher fees.	Federal Reserve
Spending	We calculate interchange fee revenue based on the assumption that 65 percent of customers use debit cards to make 20 purchases of $32.42 on average per month.	Bank On
Costs		
Program	Fixed yearly Program Administrator costs of $5M, which we increase annually with inflation.	State Treasurer
Network	Fixed yearly Network Administrator costs of $10M, which we increase annually with inflation.	Industry Experts
Card Issuing	Variable cost. We assume a $5 cost per debit card issued for production and mailing. The program incurs costs as 1) each new customer receives a card; 2) 29 percent of customers must replace their card each year due to damage, loss, or theft; and 3) each issued card expires and is replaced every 48 months.	HR&A, Mercator Advisory Group
ATM	Variable cost. We assume that 69 percent of customers use debit cards to make 2 withdrawals per month, and that 50 percent of withdrawals are in-network. Each in-network withdrawal costs the card issuer $1.03 (which we inflate annually) as the sum of switch and ATM interchange fees. Out-of-network withdrawals are free to the card issuer. Note: ATM interchange fees are different from debit card interchange fees.	Federal Reserve, Bank On, Nilson Report

HOW BANKCAL IMPACTS THE ECONOMY

BANKCAL COULD SAVE CALIFORNIA'S NEEDIEST $460 MILLION ANNUALLY

According to the Financial Health Network, in 2018 Americans spent $189 billion on fees and interest for alternative financial services. Given the roughly 60 million unbanked and underbanked Americans, these preventable expenses totals over $3,100 per person annually.

The BankCal program could help unbanked and underbanked Californians **recover some of these fees, estimated at $931 per person annually.**

The majority of BankCal savings will come from:

Single Payment Credit. Loans that are due in one payment over a short period of time, normally no longer than a month. This category includes overdraft, pawn, and payday loans.

Payment and Deposit Accounts. Intermediaries and entities involved in providing financial services and infrastructure that a bank needs to operate, each of which takes a cut (per account and/or transaction) that reduces revenue/increases costs.

$460M

Potential Cumulative Savings to California Households

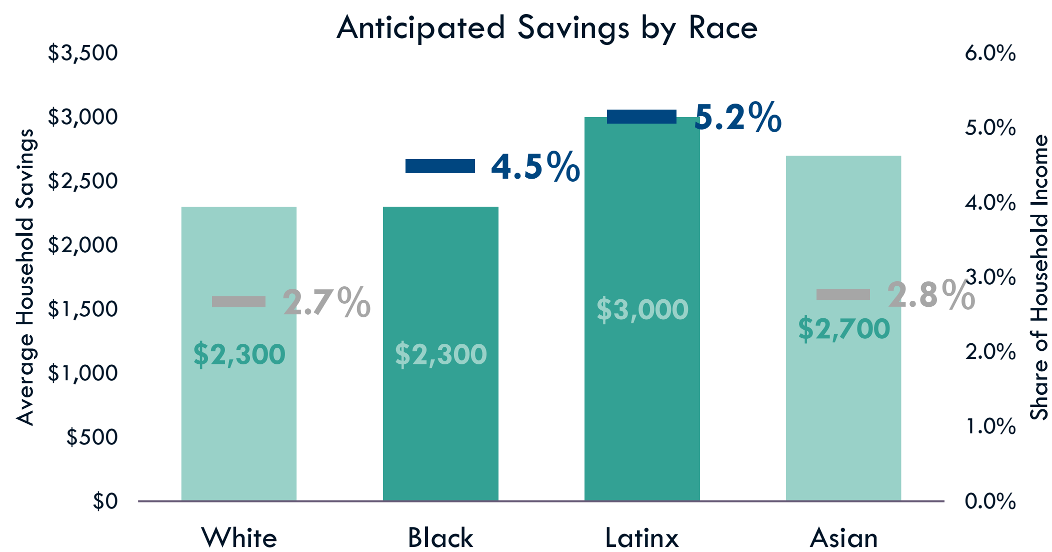
At a minimum, a financially sustainable BankCal program is set to serve a half million low and middle-income households. This translates into an estimated **cumulative household savings of $460 million in California.**

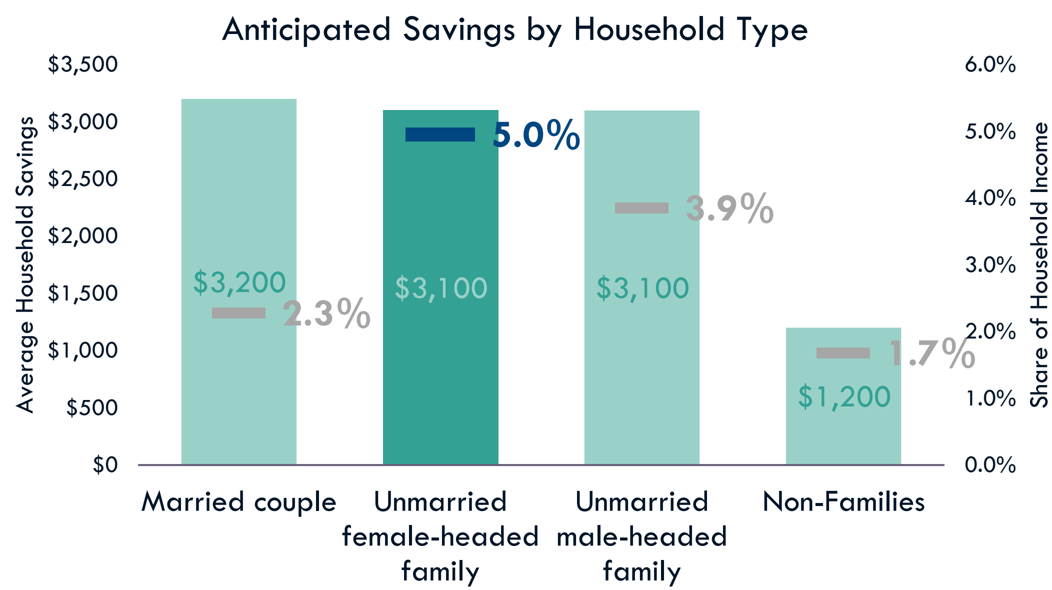
THE BIGGEST IMPACT IS ON LATINX AND FEMALE-HEADED HOUSEHOLDS

We estimate the average potential **savings from BankCal** will vary by both race and household type based on average household size.

Black and Latinx households are expected to save a higher share of their income than White and Asian households. Latinx households will save on average $3,000 per year or 5.2 percent of average income. Black households are estimated to save slightly less, $2,300, which is 4.5 percent of average income.

Unmarried female-headed households also are expected to benefit the most due to lower average household income than other household types, saving on average 5.0 percent of their annual income.





Source: HR&A, Financial Health Network, American Community Survey 2019 5-Year Estimates, ASEC 2016

IMPACT ON THE CALIFORNIA ECONOMY

>3K

JOBS CREATED

$175M

EMPLOYEE COMPENSATION (SALARY + BENEFITS)

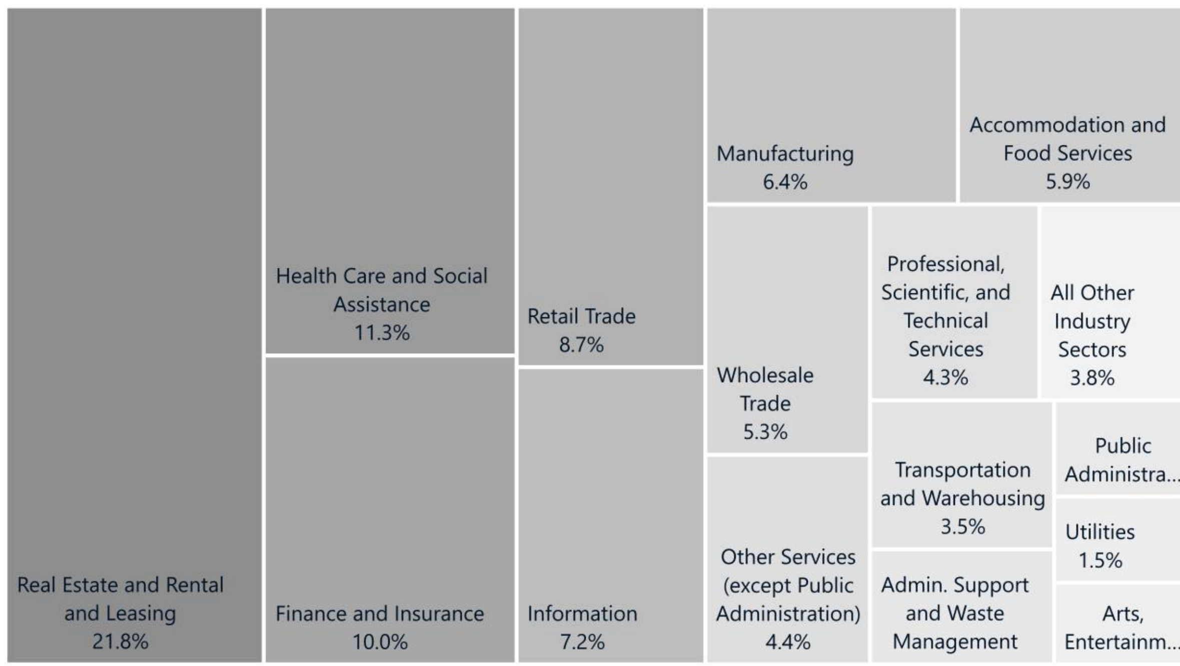
$638M

TOTAL ECONOMIC IMPACT

Redirecting household spending away from interest and fees, BankCal can support over 3,000 jobs and have a total economic impact of $638 million on the California economy. The economic analysis shows the top areas of spending are likely to be in the areas of housing, medical care, financial services, and food. This spending pattern aligns with other studies, including a recent analysis of Stockton's universal basic income pilot, which showed that when poor households receive additional funds, they tend to spend the funds on essentials.

Source: The Atlantic

Household Spending by Industry



Source: IMPLAN, HR&A Analysis