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Strengthening Banking in Inner-cities: Practices & Policies to Promote Financial Inclusion for Low-Income Canadians

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Strengthening Banking in Inner-cities: Practices & Policies to Promote Financial Inclusion for Low-Income Canadians

I) Introduction

At least 3% of Canadian adults and 8% of low-income Canadian adults have no bank account. Typically they conduct their financial transactions at what have come to be known as fringe banks, such as a cheque-casher. There, they pay higher fees for a more limited set of services than people who use banks or credit unions. Cashing a cheque may cost \$5-10 while borrowing \$100 for 12 days through a payday lender may cost \$20. Since the financial services available from fringe banks are limited to 'transactional' services such as cheque cashing and money wiring, the financially excluded cannot open savings accounts or build or repair their credit rating. In this way financial exclusion is self-reinforcing: without savings or a positive credit rating it is difficult to obtain credit cards, lines of credit, or bank loans. Since fringe banks are usually weakly regulated, their business practices vary significantly.

The number and variety of fringe banks, which operate on the margins of the financial services market primarily providing services to low and modest-middle income people, are growing. The fringe bank category generally includes payday lenders, cheque-cashers, rent-to-own shops, pawnshops, income-tax refund

advancers and sub-prime lenders (e.g., Wells Fargo). Other non-financial institution providers (e.g., President's Choice Financial) may be yet another tier of banking institution. The numbers of outlets of some fringe banks, such as payday lenders,¹ have grown rapidly in the last ten years bringing fringe banks increasingly into mainstream awareness. The Canadian Payday Lenders Association represents 500 of the 1350 outlets operating in Canada and it estimates that between 1.5 and 2 million Canadians use a payday loan every year.² Along with other fringe banks, such as pawnshops, they are often concentrated in inner cities.

The expansion of the fringe-banking sector comes at a time when Canadian banks are experiencing record-breaking profits and high levels of concentration, with the top five banks controlling 90% of all bank assets. Even as the banks prosper, there is evidence in some locales that branch closures are disproportionately hitting low-income inner cities.³

Some would argue that these changes are simply the outcomes of an efficient competitive market and do not present society with a major challenge. Alternatively,

1 Many payday lending firms provide a number of services including cheque-cashing, money wiring, money orders, bill payments, debit cards, secured credit cards, etc. They are sometimes referred to multi-service fringe banks.

2 See, Canadian Payday Lenders' Association, available: <http://www.cpla-acps.ca/english/home.php>, accessed May 2007.

3 For instance, inner-cities in Toronto, Vancouver and Winnipeg.

one might argue that these trends, when considered in conjunction with the growing evidence of stagnating incomes and assets at the bottom of the income range and a growing disparity between rich and poor, may in fact be problematic. Is it possible that the emergence of a fringe bank sector, with higher fees and limited services associated with it, will reinforce the poverty that created it?

While it is not possible here to completely rule out either of these arguments, it would seem wise for government, banks (mainstream and fringe), and community organizations to consider the possible consequences of the latter explanation. If poverty has been a primary driver of financial exclusion, then more poverty will likely result from further exclusion. Policy reform is needed to promote financial inclusion that is consistent with a national anti-poverty strategy.⁴ This paper describes the key government policies that could increase financial inclusion, including the regulation of financial institutions, consumer protection, regulation of competition and foreign investment, welfare programs, and government provision of financial services. This paper does not provide an exhaustive list of policies related to financial inclusion nor does it generate a thorough analysis on issues it covers. The

goal of this paper is to introduce the principal policies related to increasing financial inclusion.

The report begins by defining and quantifying Canadian financial exclusion and then presents various theories offered to explain it. It then proceeds to provide a set of suggestions as to how banking services can become more relevant for low-income households. Finally, it runs through a set of policy options that could promote financial inclusion. To provide evidence or examples, this paper draws on research on financial exclusion conducted in Winnipeg in the last five years.⁵

a) What is financial exclusion?

People are said to be financially excluded when they have no functioning deposit account at a 'mainstream' bank. 'Mainstream' banks are financial institutions regulated by federal or provincial legislation. They include domestic banks, foreign bank subsidiaries, foreign bank branches, trust companies, mortgage companies, credit unions⁶ and *caisses populaires*. The term 'no functioning deposit account' describes the condition of both people have no bank account and those may have an account but has not used it for several months. The financially excluded (the unbanked, or possibly underbanked) obtain financial serv-

4 For instance see, National Council on Welfare. 2007. 'Solving Poverty: Four cornerstones of a workable national strategy for Canada,' available: <http://www.ncwcnbes.net/en/contact-contactez.html>, accessed May 2007, National Council on Welfare, Ottawa.

5 For more information on this research see Buckland & Martin, 2005; Buckland, Hamilton & Reimer, 2006; Buckland *et al.*, 2003.

6 For the purposes of this report credit unions and *caisse populaires* are grouped as a mainstream bank. This is not to suggest that credit unions and *caisse populaires* operate identically to federally regulated banks. One key difference is their governance model which is based on membership not, as with banks, shareholders. Of the four community-based financial service models described in section IV, three of them are related in some fashion to credit unions and *caisse populaires*. Credit unions and *caisse populaires* may play an important role in addressing financial inclusion but their resources are limited relative to banks.

ices from informal and fringe financial service providers. Examples of informal financial services are small loans from friends or family and cheque-cashing from a corner store owner. The fringe banking sector is growing category of firms (pawnshops, cheque-cashers, rent-to-owners and payday lenders) that are weakly regulated and offer loans and basic transactions services (cheque-cashing, money wiring, bill payments).

At least 3% of Canadian adults and 8% of low-income adults are without a bank account. While there is insufficient data to say whether the problem is worsening, there is evidence that, in terms of the proportion of the population affected, it is not improving. Surveys in 1996, 2001 and 2005, all with biases that under-report low-income people, found the unbanked proportion of the adult population has stagnated at 3%.⁷ If the 3% figure is accepted as a minimum proportion of unbanked Canadians, this means that the number of unbanked has risen from 753 thousand in 1996 to over 842 thousand in 2005. If the proportion is 5%, then 1.4 million people were unbanked in 2005 (Table 1).

While these rates are lower than those in the United States (where 12-13.5% all adults and 41% low-income adults are financially excluded), they hover near the rates of financial exclusion in the United Kingdom. Since financial exclusion is concentrated among low-income people, it is more likely to reinforce poverty and other types of exclusion. Financial exclusion is often associated with reliance on fringe banks for one's financial services. Studies have found that low-income people rely on fringe bank services to a greater extent than middle and high-income people.

At fringe banks service fees are typically higher than those charged by mainstream bank services, services are focused on immediate transactions, and since there is limited government regulation, business practices can be more risky for consumers. Since fringe banks generally provide only limited transaction services and no saving services, they do not give consideration to or advice about the customer's overall financial situation. Thus financial services decisions are made without an understanding of the client's financial context.

Table 1. Minimum Number of Unbanked in Canada, 1996-2005

Year	Population	Adult Population ^a	3% Unbanked	5% Unbanked
1996	28,846,761	25,096,682	752,900	1,254,834
2001	31,021,300	26,988,531	809,656	1,349,427
2005	32,270,500	28,075,335	842,260	1,403,767
<i>a. Assuming a constant adult share of the population, at 87%.</i>				

⁷ The MacKay Report states that 3% of Canadian adults and 8% of Canadian adults with household incomes less than \$25,000 are unbanked. Due to the telephone method bias—more low-income households are without a telephone and therefore would not be interviewed—low-income households are likely underrepresented in the study. Since low-income Canadians are disproportionately financially excluded this will understate both rates. If the true figure for financial exclusion among low-income households is double the MacKay estimate, that is, 16%, then the overall unbanked rate would be higher. Adults represent approximately 87% of Canada's 32 million people, i.e., 28 million people. If 15% of these adults are low-income, then the national financial exclusion rate is = $((16\% \times 15\% \times 28 \text{ million}) + (3\% \times 85\% \times 28 \text{ million})) / 28 \text{ million} = (672,000 + 714,000) / 28 \text{ million} = 1.39 \text{ million} / 28 \text{ million} = 5.0\%$.

Fees for cashing one cheque at a cheque-casher can rival the monthly fee for a low-fee account at a mainstream bank. The annual percentage rate of interest (APR) for a pawnshop loan can hover around 250%, while APRs for payday loans range from 250% to 1000%. Higher fees reflect, in part, the costs of providing a large volume of small transactions. In some respects, fringe bank costs are higher than those experienced by traditional banks since it is less profitable for fringe banks to cash a large number of small cheques than for banks to cash a large number of cheques, many of which are for large values. Similarly banks have lower costs on their comparatively larger loans.⁸ Since cheque-cashers provide immediate cash (while banks place a hold on cheques until they clear) cheque-cashers must run the additional risk of the cheque not clearing.

Fringe banks encourage loan repayment extensions that can lead to large increases in interest rates. Their complex and undisclosed fees also represent another challenge to consumers. For example, fees for payday loans may involve three to four components, some of which are valued in dollars, while others are valued in percentages, making it very difficult to comparison shop. Finally, fringe banks gen-

erally do not offer savings or credit-building services that allow clients to build their financial position. As result, a reliance on fringe banks can, on its own, act as a barrier to becoming banked. These disadvantages can reinforce the low income and low assets that generated the connection between the client and the fringe bank to begin with, reinforcing a second tier of banking, and possibly aggravating income inequality.

b) The Poverty–Financial Exclusion Relationship

This section sketches a few of the theories that have been developed to explain the relationship between low-income people and the financial system. Two criteria that can be used to categorize these theories are their assumptions about consumer rationality and the consideration they give to the role of institutions and/or political economy. If one considers these as two continuums then it is possible to find theories that fit into four types of theories, although only three are considered here:⁹ non-rational/a-institutional¹⁰, rational/a-institutional and rational/institutional. Readers less interested in theory might skip parts (i) through (iii) and go directly to part (iv).

⁸ Excepting the cost to the firm of a bad cheque or defaulted loan. If one small cheque or loan goes bad, the loss to the fringe bank is small. If one large cheque or loan goes bad, the cost to the bank could be large.

⁹ We do not consider the non-rational-institutional theory as it has not been applied to understanding financial service choice. Early development economic theories assumed that consumers behave in non-rational ways. In the 1950s modernization theory postulated that some people, usually referring to peasants, were non-rational since they did not, for instance, respond to higher wages. These theories have been rejected for their bias towards Western notions of rationality and excessive emphasis on economic factors. Modernization theories were usually institutional in that they found that irrationality could be overcome, and development achieved with the introduction of modern education and state institutions. Modernization theories have been largely rejected in the development literature.

¹⁰ By a-institutional it is meant that the theory does not explicitly analyze the role of institutions broadly defined (referring to social and economic institutions) or narrowly defined (referring to norms and rules).

i) Non-rational/a-institutional theory

A recent theoretical approach that accepts non-rationality or 'bounded' rationality, this time largely referring to consumer behaviour has been tested by experimental or behavioural economics. This approach has sought to understand seemingly non-rational consumer behaviour, for instance when a person pays a very high fee for a loan when a lower fee alternative exists. What they demonstrate is that people behave in complex ways that do not always conform to the assumptions of consumer rationality in neoclassical economics. Paying the higher fee for a loan may reflect other economic costs (the cost of gathering information, the cost of obtaining the loan), social costs (the costs of experiencing stigma and disrespect in engaging certain services) and the impact on the consumer of advertising.

These methods and theories are very useful in unpacking the concept of rationality imbedded in neoclassical economic models.¹¹ They point to the complexity of consumer behaviour and claim that rationality is not as simple as the neoclassical model would suggest. For instance, a large experimental study of con-

sumer behaviour regarding loan choice in South Africa found that consumers behave in 'bounded' rational ways. By bounded rationality it is meant that a person cannot or does not take into account all relevant information to make her decision.¹²

One limitation of these theories is that they tend to be a-institutional: they focus on consumers' behaviour as if they operated within a perfectly competitive marketplace without institutional influence. Yet consumers do not operate in an institutional vacuum: firms' advertising and government spending on programs such as health-care, education and welfare are examples of institutional factors that affect consumer behaviour.

ii) Rational/a-institutional theory

Many theories, including neoclassical, assume that consumer behaviour is rational. According to neoclassical economic theory, if provided with reasonably priced credit, poor people can act as a cornerstone of a growing economy. This theoretical perspective has been borne out in practice. In the early 1970s, the Grameen Bank in Bangladesh under the headship of Bangladeshi Mohamed Yunus, blended modern institutional elements (staff moni-

11 Neoclassical economics is the dominant economic theory today. The roots of this approach are in the classical political economy school associated with Adam Smith, David Ricardo and Robert Thomas Malthus. But the contemporary impetus came in the late 19th century by William Jevons, Leon Walrus and Carl Menger with the application of marginal analysis to economic decision-making. It posits that consumers are rational economic agents, and that the market—free of government intervention (taxes and regulations) and other “imperfections” such as unions—is the most efficient way of distributing resources and wealth. By decentralizing economic decision-making to countless consumers and firms in many markets, neoclassical economics finds that social welfare is optimized. The theory assumes that markets are perfectly competitive (meaning that no one actor can influence market outcome) and that consumers have access to perfect information about the goods they purchase.

12 In Canada, the Center for Interuniversity Research and Analysis on Organizations, CIRANO, has an experimental economics group that has used experimental economics to look at a variety of issues including labour and financial markets.

toring and support) with those of traditional credit systems (peer monitoring and support). Yunus's pilot project has grown into a bank with almost seven-million borrowers and, perhaps more profoundly, has inspired hundreds of micro-credit projects around the world. The Grameen Bank's success, according to Yunus (who received the Nobel Peace Prize for his work), arises from the fact that poor people are rational, hard working and in fact entrepreneurial.

iii) Rational/institutional theory

An institutional theory is one that explicitly theorizes the role of institutions—broadly defined as social and political actors and processes or narrowly defined as legal rules and social norms—in the economy. Most institutional theories related to financial exclusion fit within the rational consumer category with some focussing on the micro level (the level of consumers and firms) while others focus on the macro level (the level of the nation or international economy). Sherraden and Barr (2004, 2005) use a model that is rooted in institutional economics that sees individuals operating within a social and institutional setting. It rejects the neoclassical assumption that all consumers, poor and rich operate within frictionless and competitive markets. Institutional theory sees institutions, including markets, the state and society as important intermediaries of human behaviour. This theory also rejects the idea associated with the culture of poverty theories that the poor are inherently different than the non-poor. The institutional theory of savings assumes that poor people behave like non-poor people but that they face a different set of institutions. The model assumes that individuals are “complex and their cognition and emotions can affect action,” con-

sistent with a nuanced understanding of human behaviour (Sherraden and Barr 2004, 8). Institutional theories find the greatest social and economic problems are located where both institutions and behaviour break down.

Concentrating on the macro level, Caskey (1994) argues that macro-economic trends in the U.S. explain the growth of fringe banking in the U.S. in the 1980s and early 1990s. He argues that declining incomes among working-class Americans and a growing income divide between rich and poor are demand-side (that is affecting consumers) factors that increase financial exclusion. With lower or stagnant incomes, people have fewer incentives to save and less likelihood of building a credit rating to access credit. Supply-side (affecting firms) factors that work to increase financial exclusion include the increases in fees on deposit accounts, decline in branches especially in inner-cities, reduction in non-revolving, unsecured consumer lending and small loan companies, increases in gold prices and rising awareness of the business opportunities of fringe banking. These factors make bank accounts more expensive, small loans less available and access to local banks more difficult.

iv) Institutional Theories & Financial Exclusion

This report builds on a rational-institutional theory of financial exclusion. It believes that consumers—whether low-income or not—generally behave in understandable ways that enhance their self-perceived well-being. This is not to reject insights gained from experimental economics that aid our understanding of consumer behaviour. This report embraces theories that integrate the institutional context at both the micro and

macro levels. At the macro level¹³, many of the factors that Caskey (1994) identifies as explaining financial exclusion in the U.S. may apply to Canada, e.g., declining or stagnating incomes of the poor, mainstream bank branch closures. At the micro-economic level, drawing on Sherraden and Barr (2004, 2005), it can be argued that low-income households, like all other households, pursue financial strategies that are consistent with their life goals. These financial strategies affect decisions about financial services. Households consider direct and indirect economic and social costs of mainstream, fringe and informal banking services. In general, these households choose those services that best facilitate their financial and life goals. There are, of course, limitations to information processing. Robson (2007) points out that evidence from the U.K.¹⁴ finds that many people— from various income groups— when confronted with too much information and too many options, don't shop around for, and don't fully understand their financial services.

Arguably, neoclassical economic theory is very influential on economic policy in Canada today. The theoretical framework guiding this report (rational-institutional) is consistent with the neoclassical economic framework about human rationality but deviates from it in regards to the role of institutions. Thus, this report advocates policies that may be in-

consistent with neoclassical economic theory. For instance, consumer protection flowing from neoclassical economic theory would only consider the importance of the individual and would not underscore how class, ethnicity or gender affects the consumer. An institutional theory would be concerned with how different groups, and in particular, low-income groups, are affected as consumers of financial services.

Nevertheless, to the extent that low-income people, like all other people, inform themselves about their financial services, they consider three main types of costs: direct economic costs, indirect economic costs, and social costs. Direct economic costs include all the fees applied to the service, indirect economic costs include the costs of travel and time to travel to obtain the service. Direct social costs relate to the social experience of the client with the bank staff and in particular their sense of respect and trust towards the staff and institution. The calculation of the various benefits and costs of mainstream, fringe and informal financial services can lead to surprising results. For instance, some low-income people may choose to cash their cheque at a cheque-casher even though the direct economic costs are high. This is because the indirect economic and direct social costs of fringe bank services may be low relative to mainstream bank services.

13 An important macro-level analysis is Gary Dymksi's (2003) work, drawing on the Stiglitz-Weiss new-Keynesian macroeconomic model, which argues that market imperfections such as asymmetric information and monopoly power led financial institutions to segment the financial service consumers into two groups—with low-income people being forced into doing business with sub-prime lenders and fringe banks while middle and upper-income people are streamed into mainstream bank financial services. He argues that these two market segments have become separated making it difficult for low-income people to move into a relationship with mainstream financial service providers.

14 For instance see, Atkinson, McKary, Collard & Kempson, 2007.

II) Tailoring financial services for low-income people

The delivery of financial services by banks in useful, convenient and respectful ways is a key to increasing financial inclusion. This can be done by ensuring that information about financial services and products is easily available, developing products that meet the unique financial needs of low-income people, and providing these services in respectful ways that give clients a sense of control over their lives.

a) Information about financial services & fees

A consumer requires an understanding of a product, including its characteristics and fees, before she can determine if it meets her needs. Low-income people face two related information problems when they seek out financial services. Mainstream banks do not widely publicize those services that they provide that would be of relevance to low-income people while information about fringe bank fees is often not presented or presented in an overly complicated manner.

Relevant information about a bank account includes: how to open an account (personal identification requirements), how to maintain it (minimum balances, how many free transactions), and the monthly fee. Banks are required to accept certain types of personal identification to cash cheques and open accounts, they have voluntarily agreed to provide a basic 'low-fee' account (usually \$4-\$6 a month for 10-15 transactions) and banks have agreed to cash federal government cheques of up to \$1,500 for no fee. While

banks provide these services, the services are not necessarily well publicized.

Services offered by fringe bank are often better advertised than basic bank services at mainstream banks. However, fee information may not be presented in an easy-to-understand manner. Administration fees, cheque-cashing fees, interest charges can be applied in a lump sum or in variable, daily or monthly rates, making it very difficult to determine the total fee for a fringe bank service. This renders it all but impossible to shop around for the best financial service. This is important since fringe bank fees can vary from firm to firm. In Winnipeg, while pawning fees are consistent across shops, cheque-cashing fees vary somewhat and rent-to-own and payday loan fees vary considerably (Buckland *et al.*, 2003).

A variety of policies could be introduced to make financial services more accessible to low-income people and to make information about the cost of those services more understandable. While banks have agreed to accept standardized personal identification requirements, open low-fee accounts and not charge for cashing federal government cheques, they could also be required to publicize these services and policies. Banks could provide information about these services on posters in the branches and broadly advertise these services in the same way the fringe banks advertise their services.

The joint federal, provincial and territorial Consumer Measures Committee¹⁵

15 The CMC "provides a federal-provincial-territorial forum for national cooperation to improve the marketplace for Canadian consumers, through harmonization of laws, regulations and practices and through actions to raise public awareness", Consumer Measures Committee, available: <http://cmcweb.ca/epic/site/cmc-cmc.nsf/en/Home/>, accessed May 2007.

has proposed a method to calculate complex fee formulas in a way that accurately discloses total fees. It requires that all loan fees be combined in a lump sum and then converts that sum into an annualized interest rate, or an annual percentage rate.¹⁶ There should be a requirement that the fees for other fringe and mainstream bank services—such as cheque-cashing, money wiring, bill payments—be disclosed in such an easily comprehended manner that allows comparison of fees across firms.

Consumers have the right to file complaints about financial services with the Financial Consumer Agency of Canada and provincial consumer's bureaus. It is important that low-income consumers be made aware of these mechanisms. Aside from complaints from the public, the FCAC also undertakes mystery shopper investigations. In this method, an 'undercover' or mystery shopper enters the bank branch, and engages staff to survey the quality of service the staff and bank provide. Presently FCAC regularly undertakes, through contracting agencies, mystery shopping of banks' compliance with particular regulations (e.g., account opening). It would be useful if agencies performing mystery shopping ensured that vulnerable consumers are represented as mystery shoppers. Otherwise, the results of the mystery shopping method may not be useful for understanding the experience of low-income consumers.

Conacher (2007) notes that FCAC's mys-

tery shopping investigations in 2003 found banks breaching several regulations by not having a clear, publicly available policy on holds on cheques; by engaging in tied selling; and by failing to post notice of branch closure. The FCAC Commissioner did not prosecute any of these banks, and, as a result, the names of the offending banks were not publicly reported. The 2004-5 FCAC (2005) mystery shopping research tested bank policy on opening an account and cashing federal government cheques. Of the 292 attempts to open accounts, 48 accounts (16%) were declined. Of the 212 attempts to cash a federal government cheque, 20 (9%) were unsuccessful. Contrary to regulations, written letters of refusal by the banks were not provided in 90% of the cases involving refusing to open an account and 95% of the cases involving refusing to cash a cheque (Conacher, 2007).

b) Building respectful & trustworthy relationships

Research conducted in inner-city Winnipeg found that some low-income people feel that they are not respected by, nor do they trust mainstream banks and other large institutions (Buckland and Martin, 2005). The research found that some low-income people feel fringe bank staff is more respectful towards them than mainstream bank staff.

Banks could build more respectful relations with low-income people by provid-

16 See, Cost of Credit Disclosure–Working Group, Consumer Measures Committee. 2005. 'Consultation on Cost of Credit Disclosure–January 2005,' available: <<http://cmcweb.ca/epic/site/cmc-cmc.nsf/en/fe00089e.html>>, accessed May 2007; and see, Alternative Consumer Credit–Working Group, Consumer Measures Committee. 2005. 'Alternative Consumer Credit Market Consultation: Stakeholder Consultation Document on a Proposed Consumer Protection Framework for the Alternative Consumer Credit Market,' available: <<http://cmcweb.ca/epic/site/cmc-cmc.nsf/en/fe00085e.html#items>>, accessed May 2007.

ing more appropriate types of services (discussed below). In addition, banks could provide staff with more training about the particular financial service needs of low-income people. Because of the way various welfare programs are structured and, in particular, how a person's current and future welfare payments and tax liabilities change as one's income rises, providing helpful advice on financial services to low-income people poses its own technical challenges.¹⁷ Bank staff need to be aware of these challenges, if they are going to be able to provide advice that meets the needs of low-income people. Hiring of local people with knowledge of the neighbourhood and its residents is an obvious way to ensure staff has this knowledge and sensitivity. Some notable community banking projects have hired local people in order to successfully develop rapport with the community (see below).

The customer's sense of control over her account and her level of trust of the bank can serve as barriers that limit low-income people's use of banks. For example, mainstream bank accounts often automatically debit accounts, without the customer's knowledge. With fringe banks usually fees are deducted at the moment of the in-person transaction. Automatic debits can lead to a breakdown of customer trust if the customer has not recorded the transaction or if the bank makes a mistake. Two steps could be taken to improve the customer's sense of control and trust.¹⁸ First, banks might provide clients with training in financial management that includes a component on the characteristics of deposit accounts. Since this cannot be a requirement for

accessing an account, it might be useful to provide incentives for participating in these programs (for example, access to special savings accounts). Second, banks must inform clients about federal and provincial agencies to which they can direct any financial service complaints.

c) Accessibility to financial services

Research has found that many low-income people believe mainstream bank services are not sufficiently accessible (Buckland and Martin, 2005). As mainstream banks direct their services towards middle- to high-income people they have disproportionately closed branches in inner cities. Banks argue that new technologies such as automatic teller machines (ATM), point-of-service (POS) machines, telephone and Internet banking can fill the gaps created by branch closures. But these technologies do not necessarily assist low-income people, who are less likely to own cars, telephones, or computers with Internet connections. There is some evidence that lower income people as compared with others may have a greater preference for in-person over automated transactions (Ekos Research Associates Inc. 2001, 17, 19; Cheron *et al.*, 1999, 54). Fringe bank services, on the other hand, are more accessible as outlets have opened in the inner cities and operating hours are long.

Mainstream banks have tended to reduce the provision of services of relevance to low-income people, for example, small loans. The costs of providing such services are relatively high and net lower returns for banks when compared to the

17 I am grateful to Jennifer Robson and Rick Eagan for this insight.

18 SEDI refers to this as increasing a person's awareness of their rights and responsibilities vis-à-vis financial services (Robson, 2007).

returns received for other services. A case could be made that it is the banking sector's long-term interest to invest in inner-city outlets and appropriate financial services since as low-income people become financially included, their own income and asset positions may improve, leading them to purchase more lucrative bank products. However, there will be some clients who will likely always rely on basic banking services. Banks are unlikely to see these clients as a strategic market and are therefore unlikely to invest in branches and services that meet their needs. Government intervention may be required to support this type of financial inclusion.

d) Appropriate financial services

The provision of basic banking services in an accessible branch is a starting point for financial inclusion. However, this is not the only barrier to the financial inclusion of low-income people. Mainstream financial institutions need to provide a range of additional services that meet the distinct financial needs of low-income people. It is, for example, a mistake to think that just because low-income people have small incomes, small savings, and small credit needs that their financial needs are insignificant. The following preliminary list of new service ideas below is based on research conducted in Winnipeg by the author and draws on relevant academic literature.¹⁹

i) Savings schemes

It is sometimes argued that people with low incomes do not or cannot save. Em-

pirically this does not hold up. Evidence from diverse low-income settings ranging from Bangladesh, India, South Africa and in Canada demonstrates that low-income people can and do save. Their savings are done in diverse and informal ways, e.g., savings/credit circles,²⁰ 'money-jars,' the purchase of re-saleable consumer durables are some of the ingenious ways in which low-income people save. Saving options in fringe banks are seriously limited (e.g., the purchase of money orders) and we have already said that bank branches and services may not be accessible. Mainstream banks might offer savings instruments that are flexible and designed with the needs of low-income clients in mind. The following are some ideas to consider:

- The provision of a free, interest-bearing savings account to checking account holders would allow the client to regularly save. The account might have optional restrictions on withdrawal of funds that would facilitate the accumulation of savings.
- These savings accounts may be appropriate to use in conjunction with asset building programs. These programs can encourage low-income people to build personal assets by saving for investments education and business. These programs usually require that the participants meet certain criteria and participate in financial management training and on-going peer support group meetings. Their savings are typically matched (by government

19 This is a preliminary list that would need to be tested directly with participants and, ideally, be developed as pilot projects and if successful, scaled up.

20 In many parts of the global South ROSCAs, rotating savings and credit associations, and ASCRAs, accumulating savings and credit associations, are a common part of the informal economy used to save and access credit.

or donor agency), and when the savings reach an agreed upon level they are released on the condition that they used for the original purpose of the savings. These programs might be best facilitated with community organizations that work with low-income residents.

ii) Credit schemes

Many low-income people use informal and fringe financial services for a variety of their credit needs. These include, savings/credit circles for loans, reciprocal or one-way credit partners, pawnshops, cheque-cashing services, rent-to-own and payday loans. Some argue that low-income people are unable to manage credit. Yet research and practice from around the world has demonstrated that high income is not a requirement for a person to manage credit. Tens of millions of low-income people regularly borrow from institutions such as Grameen Bank in Bangladesh, Bancosol in Peru and Bank Rakyat in Indonesia. These borrowers pay significant interest payments and repay their loans in a timely fashion. Because low-income people are less able to provide physical collateral, many of these programs use social networks/peer monitoring or support via credit circles, or intensive staff monitoring to ensure high repayment rates. The following are some ideas to consider:

- Credit programs could be designed to foster careful investment and repayment. This might be done by limiting participation through the use of social networks (peer support) and local organizations (referrals). The Community Financial Service Centre in Winnipeg takes this approach. Loan systems might include some level of subsidy that would be

available to clients meeting certain criteria, e.g., completing financial management training, ongoing peer-support meetings, and meeting repayment deadlines. To assist low-income people and encourage self-selection, loan amounts should be kept small, perhaps \$50-\$100.

- Credit from informal and fringe sources limit a person's ability to improve her credit rating. Timely repayment of pawn loans, payday loans and family-based loans do not improve a person's credit bureau score. As a result, the well-disciplined fringe bank borrower is not rewarded with access to cheaper and more flexible credit through an improved credit rating. In the case of a carefully designed program it would be helpful for the client's credit history to be reported to the credit rating agency.
- Using new technologies such as secured credit cards to deliver credit is another idea. The secured credit card limits the holder's credit to the amount of funds placed by her in a secure account at the bank. By securing funds at the bank a credit card can be an efficient way to provide credit to the financially excluded. These have been successfully used in the U.S. and are becoming more common Canada (for example, Assiniboine Credit Union, Vancity Credit Union).

iii) Tailor financial service technologies for low-income people

Financial service technologies such as credit and debit cards, delivery systems such as ATMs, POS systems, telephone and Internet banking have dramatically changed the ways in which financial

service are delivered in Canada. However, these technologies are not equally useful for all people. Low-income people are more likely to live in neighbourhoods with few ATMs, not own a phone, or a computer with an Internet connection. To promote financial inclusion, these technologies must be tailored to the needs of low-income people. On their own they are insufficient to overcome financial exclusion. However, in combination with other changes—like better savings and credit products—they could assist low-income people if they are accessible. The following are some ideas to consider:

- Since there may be an insufficient volume of business to justify the commercial installation of these systems in inner cities, government and community organizations could partner to locate them in publicly accessible offices such as libraries and drop-in centres.
- New card technologies relevant for financial services include secured credit cards (described above), pre-loaded debit cards (e.g., retail gift cards), ‘smart’ cards (technology allowing funds to be stored on card as opposed to linking to an account). Banks and government programs may use these for general use of particular groups. If these cards reduce the costs of financial transactions and are linked to mainstream banks they may offer bridges to financial inclusion for low-income people. By depositing funds in a secured account, the secured credit card offers a simple way to collateralize debt and allows for repairing and building credit scores. Pre-loaded debit cards may also expand access to financial services although fees for some cards are relatively high (e.g., cards available through some fringe banks).

III) General types of government action to promote financial inclusion

Either on their own or in conjunction with other actors, government could promote financial inclusion through policies and service provision. Given the correlation between poverty and financial exclusion, it is important that a financial inclusion strategy be consistent with an anti-poverty strategy.

a) Government policy

A broad range of federal and provincial government policies, from regulating basic banking through promoting competition in financial markets to welfare policy, can affect financial exclusion rates. We review the policies of most relevance to the challenge of financial exclusion.

i) Regulating & supporting basic banking services

Small transactional financial services are expensive to provide. Fringe banks are able to offer some of these services but at fees higher than mainstream banks. Can government support, encourage or require mainstream banks to provide more outlets and services to build financial inclusion? There are different ways that some governments have approached this challenge. One type of regulation seeks to ensure that basic banking services—deposit accounts and cheque-cashing for instance—are provided by banks. Regulations in Canada are found in the 2001 Bill C-8, the ‘Access to Basic Banking

Regulations.’ In the U.S. the principal way this is achieved is through the 30 year old Community Reinvestment Act. Other countries use a variety of policies with greater or lesser effectiveness.²¹

1) Requiring banks to provide a minimum set of banking services at all branches

During the late 1990s, the Canadian government explored ways to liberalize (i.e., to deregulate) the banking system. The pressures to deregulate are rooted in neo-classical economic theory and driven, hypothetically, by global trade negotiations associated with the World Trade Organization’s (WTO) General Agreement on Trade in Services. GATS seeks to expand trade in services through the removal of non-tariff barriers and reducing tariffs. Through the WTO’s predecessor, the General Agreement on Tariffs and Trade (GATT), trade liberalization had advanced significantly in manufactured goods. With the creation of the WTO in 1995, greater emphasis was placed on the liberalization of world trade in services and agriculture.

In 1996 the government established the Task Force on the Future of the Canadian Financial Services Sector, which produced *Change, Challenge, Opportunity* (known as the MacKay Report) in 1998. In regards to consumer protection it stated, “the current framework for con-

21 For a brief description of these types of regulations in eight countries (Australia, Brazil, Canada, India, Nigeria, South Africa, U.K. and the U.S.), see Feltner and Buch, 2004. Robson (2007) noted that the U.K. has introduced a third way to ensure access to basic banking. In this case banks are required to provide services for certain types of public programs, specifically pension and child trust accounts.

sumer protection is not as effective as it should be in reducing the information and power imbalance between institutions and consumers” (MacKay Report 1998, 15). In 1999 the government response to the MacKay report, *Reforming Canadas Financial Services Sector: A Framework for the Future*, called for, among other things, the establishment of a financial consumer agency, and improved access to basic banking for the financially excluded. The report provided the foundation for Bill C-8.²² This bill included the “Access to Basic Banking Service Regulations” and led to the creation of the FCAC in 2001.

Access to basic banking regulations requires that banks open deposit accounts for all persons, including unemployed persons, as long as they have appropriate personal identification. The regulations also describe the numbers and types of identification that are acceptable. In addition, the regulation requires that banks cash federal government cheques to a maximum of \$1,500 for no charge for non-customers with similarly appropriate identification. FCAC monitors compliance with these regulations through its consumer complaint telephone line and mystery shopping. Consumer complaints can lead the FCAC Commissioner taking action, with sanctions ranging from a letter of reprimand to monetary penalties.

While these regulations may promote financial inclusion they have several limi-

tations. First, part of the compliance is based on consumer complaints. As mentioned above, many low-income consumers may be reluctant or unable to complain. Second, even if banks comply with the regulations they may make other business decisions that make accessing basic financial services for the poor very difficult. Banks may close branches in inner cities where a large proportion of the poor live, raising the travel costs to open an account. Inadequate or inappropriate training of staff on the particular financial needs of low-income people can also create a barrier to banking for low-income people.

2) Requiring banks to demonstrate universal provision of banking services in entire working area

In the U.S., the Community Reinvestment Act (CRA) requires financial institutions to provide such services as access to consumer and small business credit, access to branch locations, access to community development credit to all people and businesses within their geographic work area. The legislation is meant to prevent banks from ‘redlining’ neighbourhoods (redlining refers to the practice of closing branches and not providing services in low-income and/or remote locations). The CRA establishes a number of tests that assess each bank’s adherence to the Act and the results of these tests play a role in government decisions on bank mergers and charter applications.²³ While the CRA has faced recent political

22 Bill C-8: “An Act to Establish the Financial Consumer Agency of Canada and to Amend Certain Acts in Relation to Financial Institutions (FCA Act) of 2001” (Government of Canada, 2002, ‘Access to Basic Banking Services Regulations’ Canada Gazette Vol. 136, No. 48 - November 30, 2002, Available: <http://canadagazette.gc.ca/part1/2002/20021130/html/regle-e.html>).

23 See, Office of the Controller of the Currency, 2002, ‘Community Reinvestment Act and Interstate Deposit Production Regulations’ Accessed May 2007, <http://www.occ.treas.gov/fr/cfrparts/12cfr25.htm#%A725.29> Effect of CRA performance on applications.

challenges,²⁴ it has been in place for 30 years and, according to one study, has helped pump \$4.7-trillion into community reinvestment.²⁵

CRA regulation is potentially more comprehensive than Canada's basic banking access regulations. Canada's banking regulations for example, do not address branch closure concerns, inappropriate bank services and discourteous service provision. U.S. CRA supporters argue that the CRA is justified because of market imperfections and is effective in promoting financial inclusion. Barr (2005) finds:

At its core, CRA helps to overcome market failures in low-income communities. By fostering competition among banks in serving low-income areas, CRA generates larger volumes of lending from diverse sources, and adds liquidity to the market, decreasing the risk of each bank's loan.

Encouraged by the law, banks and thrifts have developed expertise in serving low-income communities, and they have created innovative products that meet the credit needs of these areas with manageable risks (Barr, 2005, 2).

The CRA has led to the creation of partnerships between financial institutions and community organizations (Barr, 2005, 2; Robson, 2007) that assist the community organizations in addressing financial exclusion. Conservative critics argue that the CRA, rather than overcoming market failure, actually creates it.

This is in keeping with their general view that any government intervention undermines market efficiency. Leftist critics argue that the CRA, for all its benefits, still leaves millions of Americans without bank accounts. Proponents of this view generally call for the strengthening of the CRA as opposed to its removal (Smith, Bush and Paufve 2007).

Canadian policymakers and financial institutions have shown little interest in replicating the CRA. This might be explained by the fact that the proportion of unbanked is lower in Canada than in the U.S.. However, Conacher (2007) has argued for CRA-style legislation in Canada is justified since Canadian banks receive government protection from foreign competition through bank regulation, have earned high profit rates, charge high credit-card interest rates and have closed branches in vulnerable markets. Conacher argues:

So 30 years ago, the government of the country commonly identified with capitalism [the U.S.] recognized that banks provide essential services. Even in the presence of healthy competition, laws were needed to ensure these services are provided fairly at fair prices *because they are essential to the economic health of individuals, businesses, communities, and the economy overall* (Conacher, 2007, 14).

Existing basic banking access regulations have not prevented the development of financial exclusion in Canada. Banks might provide basic accounts and

24 See for instance, Woodstock Institute. 2007. 'Measuring the Provision of Banking Services for the Unbanked: Recommendations for a More Effective Community Reinvestment Act Service Test,' Reinvestment Alert, Number 31, Chicago.

25 National Community Reinvestment Coalition, 2007, 'The Community Reinvestment Act: Trillions of Dollars of Loans and Investments for Low- and Moderate-Income Communities,' Accessed May 2007, <http://www.ncrc.org/policy/cra/documents/CRAat30.pdf>.

accept certain forms of identification, but they close inner-city branches and seem to make little headway, with a few exceptions, in developing services and products for low-income people. Financial institutions have to be key players in solving the financial exclusion problem. While a CRA may be one way to force the banks to participate in devising solutions, the U.S. experience is mixed. There are other means to provide basic banking.

3) Supporting local solutions

To build financial inclusion government could also respond to local initiative and partner with banks and community organizations in developing new financial service models. Government partnership decisions should be made on an assessment as to whether the community proposal addresses strategic policy goals and works with a financial organization. In most cases, the government would not become involved until community organizations have identified local needs and are looking for partners to develop locally-appropriate solutions. Government could provide the partnership with funding, policy, technical and/or organizational support. This approach, which is flexible and rooted in the local context, could foster pilot projects that seek to develop services and models appropriate for low-income people and neighbourhoods.

Canadian projects of this sort include Vancouver's Pigeon Park Savings, Toronto's Cash and Save, Winnipeg's Community Financial Services Centre and Quebec's Desjardins Federation micro-loan program. Each of these unique programs involves a variety of different actors from community organizations, financial institutions and government.

- The Community Financial Services Centre, based in Winnipeg's North End, collaborates with partners to provide financial management training, access to a credit union accounts and microloans. The creation of a neighbourhood renewal corporation, North End Community Renewal Corporation, the CFSC works with a major credit union in Winnipeg, Assiniboine Credit Union, and receives funding through the tripartite government grant from the Winnipeg Partnership Agreement. It has a growing client base of over 100.
- Pigeon Park Savings (PPS) is a branch of Vancity Credit Union based in Vancouver's Downtown Eastside. It is managed and staffed by PHS Community Services Society, a large non-profit working in the area on housing, health and work skill development programs. PPS serves over 3,500 clients, largely from the immediate area. Vancity provides the computer system, staff training, undertakes backroom processing and provides funding to cover a gap in operating costs.
- The Cash and Save, a subsidiary of RBC Financial Group, operates two outlets in two Toronto low-income neighbourhoods: Parkdale and Regent Park. The outlets offer cheque-cashing and other financial services, priced below fees at most fringe banks. In developing the Cash and Save, RBC worked with a neighbourhood community organization, St. Christopher House, to identify local need and with a consulting agency Bain and Company that provided its services *pro bono*, to develop the business plan.

- The Desjardins micro-loan project is sponsored by the Federation des caisses Desjardins du Québec in partnership with a *caisse populaire* and a credit counselling agency. The federation and the *caisse* provide a capital base from which micro-loans are made to low-income consumers who work with the financial counselling agency. There are approximately 26 partnerships today involving micro-loans through 255 *caisses* across Québec. As of 31 March 2007, a total of 1,949 loans were made averaging \$542 and the repayment rate was 89 percent.

A government strategy that supports local initiative has many strengths: it responds to locally identified need most likely in a way that supports local capacity. However, since this approach depends on local organizations to initiate the process, financial exclusion in certain regions and groups may not be addressed. In addition, the process may not lead to provision of all the services that are required to overcome financial exclusion.

ii) Consumer protection

Consumer protection regulation is intended to protect consumers from unsafe or unfair business practices. In the financial sector, these practices include unfair price disclosure, tied selling schemes, unfair collection of debt and salary garnishment.

Unfair price disclosure can occur when a product's fee is made up of a series of com-

ponents, some of which may be in dollar or proportional rates that are not clearly posted or explained. As discussed above, this practice is common in fringe banking and makes it difficult for the consumer to shop around.

Fair price disclosure would require service providers to combine all fees into one figure. In the case of loans, all fees would be calculated as an annual percentage rate, APR.²⁶ This would allow the consumer to compare the total fee for the payday or rent-to-own contract offered by different competitors. Manitoba is in the process of requiring lenders (including payday lenders, rent-to-owners, etc.) to express their fees in this manner. Other provinces and territories may follow suit now that the federal government has granted an exemption to payday lenders to the Criminal Code provisions that limited the amount of interest they could charge. Section 347 of the Criminal Code of Canada specified that it was illegal to charge annualized interest rates in excess of 60%. Since almost all fringe banks offering credit charge APRs in excess of 60%, introducing a fair price disclosure policy would provide clear evidence that fringe banks almost universally break the Criminal Code. The exemption—akin to an exemption for income tax advance firms—allows payday lenders to charge above the criminal rate of interest.

Tied selling arrangements are those in which the firm ties the sale of one good or service, such as a payday loan, to another good or service such as cheque-cashing. It would also be disallowed, in-

26 The Alternative Consumer Credit-Working Group of the Consumer Measures Committee has developed a method to convert small loan fees into an annual percentage rate, APR. All fees (interest, administration, cheque-cashing, etc.) would be lumped together and then annualized. This would be appropriate for payday lenders, rent-to-own firms, pawnshops, etc. All fees (interest, administration, cheque-cashing, etc.) would be lumped together and then annualized.

creasing the options to the consumer. The *Bank Act* prohibits banks from engaging in tied selling. Unfair collection of debt is where the creditor uses excessive pressure or violence to force repayment. There have been concerns expressed that some fringe banks might aggressively pursue overdue accounts. For instance, wage garnishment, where the creditor arranges with the debtor's employer to take a portion of her wage each pay period, is sometimes used by fringe banks to ensure debt repayment. In some cases payday lenders require clients to sign a wage garnishment authorization contract before receiving the loan. While wage garnishment may be court-ordered, firms cannot independently require wage assignment.

Consumer protection is largely a provincial responsibility. In Manitoba, the Consumers' Bureau is responsible for investigating consumer complaints related to unfair debt collection. The FCAC is responsible to deal with consumer complaints about mainstream banks and access to basic banking services (see below).

Consumer protection laws seek to protect consumers from 'outlier' or atypical firms that are gouging the consumer. They are based on a premise that aside from such rogue firms, the market operates in such a way to benefit most people. It is based on the concept that markets are competitive (which is not always the case, see below) and that society is harmonious and that social exclusion is uncommon. However, there *are* socially excluded people, for example, many Abo-

original people, inner-city poor, and the financially excluded.

These flawed assumptions mean that consumer protection law gives little consideration to the disempowered position of socially excluded people and is consumer-complaint driven. It is the responsibility of the consumer who had the bad experience *and* who knows about her rights *and* knows about the Consumer's Bureau or FCAC to make the complaint. Then the Bureau or FCAC will investigate and seek some sort of resolution. Many low-income consumers may be reluctant to complain since they feel it would not be useful, they distrust large government and business institutions, they are too busy, or they do not know about or are unable to use (lacking transportation, telephone, or a computer and an Internet hook-up) the complaint mechanism. As a result, low-income consumers may have less consumer protection than other consumers and are arguably less likely to be aware of and able to take advantage of complaint mechanisms.

It is possible to develop consumer protection regulations that identify which consumers are particularly vulnerable (see Ramsay 2001) and then establish ways to ensure that their rights are enforced. Given the rapid growth of fringe banks (especially payday lenders) in the last decade across the country, the federal government needs to take leadership in developing effective consumer protection. More widespread use of appropriate forms of mystery shopping may offer one solution.²⁷

27 Mystery shopping is a research method to determine the quality of service provision. In this method, an 'undercover' or mystery shopper enters the retail shop, like a bank branch, and engages staff to survey the quality of service the staff and retail shop provide. Presently FCAC regularly undertakes, through contracting agencies, mystery shopping of banks. It would be useful if agencies performing mystery shopping ensured that vulnerable consumers are represented as mystery shoppers. Otherwise the results of the mystery shopping method may not be useful for understanding the experience of low-income consumers.

iii) *Ensuring competition in financial markets*

Consumer protection regulations can effectively control 'rogue' firms when markets are competitive. But what does it mean for markets to be competitive? Under conditions of 'perfect competition', as envisioned in neoclassical economic theory, the market is made up of a large number of buyers and sellers. In such a market, no one player—either buyer or seller—can affect the market outcome. Producers are said to be 'price-takers,' in that they cannot dictate price but, faced with a market price, they choose how much product to supply. In this type of market the consumer fares the best. When a market is imperfectly competitive, which is the reality in many sectors in the Canadian economy, then there is no guarantee that the market is working in the best interests of consumers. There are many variations of imperfect competition but three types are most common: monopoly (one seller, for example, De Beers and the diamond market), oligopoly (a few large sellers) and monopolistic competitors (many sellers but heterogeneous product). The monopolistic competitor seeks to differentiate its products by spending large sums on advertising. The outcome of excessive advertising can be harmful: it can raise the costs to the product, it can unfairly influence consumers and it can feed into overall excessive con-

sumption that is harmful to the environment and society.²⁸

Even if markets are sufficiently competitive at the national level, it is possible that certain locations—inner cities, remote rural areas—will experience imperfect competition such as oligopoly or monopoly. In these cases it is possible for banks to behave in ways that are at odds with consumer interests. For instance, considering the mobility constraints faced by low-income people concentrated in inner-cities, bank branch closures may create a situation where the only feasible banking option is a fringe bank such as a cheque-casher/payday lender. With a spatial monopoly it is possible for a firm to pursue business strategies such as unfair price disclosure, aggressive collection practices and monopolistic pricing that hurt the consumer.

In Canada, the Competition Bureau is responsible to enforce the *Competition Act*, which seeks to ensure markets are competitive leading to fair prices and quality products.²⁹ In the late 1990s, when four major banks³⁰ sought to merge their operations into two operations, the Competition Bureau investigated how this might affect the market.³¹ The merger applications were denied based on the findings, "the Commissioner determined that the proposed mergers, as they were presented, would likely lead to a substan-

28 For an example of a study exploring this issue, in the case of the consequences of bank mergers on rural areas in British Columbia see Bowles (2000).

29 See Competition Bureau Canada website at: <http://canadagazette.gc.ca/part1/2002/20021130/html/regle-e.html>.

30 The proposed merger of the Royal Bank of Canada with the Bank of Montreal and the Canadian Imperial Bank of Commerce with the Toronto-Dominion Bank were reviewed by the Competition Bureau 1998.

31 For a general discussion of the Competition Bureau's process of reviewing bank merger application see, Competition Bureau Canada, 'The Competition Bureau and Bank Mergers,' <http://www.competitionbureau.gc.ca/internet/index.cfm?itemID=825&lg=e>.

tial lessening or prevention of competition that would cause higher prices and lower levels of service and choice for several key banking services in Canada.”³²

That the Competition Bureau investigated and denied these mergers has arguably maintained the existing level of competition. However, the bureau has not extended its analysis and enforcement to examine the existing level of competition in the financial services marketplace nationally or in certain regions such as isolated rural areas or inner cities. Conacher (1998) argued that the Competition Bureau’s analysis of level of bank competition during the merger review process was insufficient. Conacher’s critique noted that,

- The Bureau’s analysis was not transparent regarding the definition of geographic and product units analyzed
- The Bureau excluded consideration of the bank’s record profits as evidence of market power
- The examination ignored issues of substitutability of different financial services, failing to ask, for instance, if Internet banking is a perfect substitute for a local branch
- The Bureau measured market concentration within inappropriate geographic boundaries—using Canada Post forward sortation area, which can vary from one building to an area of over 1,000 square-kilometre, instead of something more geographically uniform such as census tracts. Using census

tracts might show existing levels of competition in certain locales to be insufficient.

The Competition Bureau responds to consumer complaints about unfair market activities. Once again, low-income and inner-city citizens are less likely to take advantage of this because of obstacles mentioned above. Because of greater reliance on fringe banks on the part of low-income Canadians, it is important that the Competition Bureau assess the competitiveness of the fringe bank markets. The fact that there are two large firms in the payday lending market reinforces the importance of ensuring competition (see next section).

A more competitive mainstream and fringe bank market, both nationally and within particular regions, is important for financial inclusion. The Competition Bureau should more carefully analyse the nature of the financial service industry in Canada and pay particular attention to vulnerable locales such as remote rural areas and low-income inner cities. It should consider competition among, and between, mainstream and fringe banks. Evidence of excessive profit rates, advertising expenditure and brand proliferation may indicate imperfect competition. If markets are imperfectly competitive, then firms might be required to provide information about their costs and returns to demonstrate that their profits are not excessive.

iv) Ensuring foreign investment benefits the economy

The review of foreign investment is intended to ensure that it is in the best

32 Competition Bureau Canada, ‘Annual Report 98/99 - Reviewing Mergers,’ available: <http://www.competitionbureau.gc.ca/internet/index.cfm?itemID=1549&lg=e>.

interests of the Canadian economy and society. In Canada such review has declined since the 1970s when economic nationalism was more pronounced and there were concerns that certain types of foreign investment could have a negative impact on the Canadian economy. For instance, foreign investment that did not create many new well-paying jobs or involved large transfers of profit to the parent company would be considered less desirable. The Foreign Investment Review Agency was established in 1973 to review foreign investors' plans for new investment and proposed purchases of existing facilities. However, in 1985 the agency's name was changed to Investment Canada and its focus shifted from controlling foreign ownership to promoting domestic and foreign investment.³³

This strategic policy shift was consistent with Canada participating in the founding of the World Trade Organization in 1995 and with the liberalization of financial services during the late 1990s and early 2000s. Financial sector liberalization gave Canadian banks more scope to invest internationally. It also gave foreign banks greater access to the Canadian economy, allowing them to either open a

branch (and face a high level of regulation)³⁴ or establish a Canadian subsidiary (and face reduced regulation).³⁵ Liberalization was based on the premise that foreign investment would, by increasing overall investment and competition, ultimately benefit consumers. However, foreign investment does not always increase total investment—it may, for example, actually draw on local capital, thus diverting it away from local users. Foreign investment also does not necessarily stimulate competition since a large foreign investor may simply dominate the industry.

Conacher (1998) also raises some important questions about just how open the Canadian financial services sector is to foreign investment. He argues that while legal barriers to entry have declined with the WTO General Agreement on Trade in Services, Canadian banks enjoy a variety of protections from foreign banks including “widespread consumer name recognition,” and extensive existing branch networks. Conacher concludes, “As a result of these many barriers to entry, there are fewer foreign banks in Canada now (43) than there were in 1987 (when there were 59) and their combined assets amount to only \$92 billion (7% of

33 See Canadian Encyclopaedia, Foreign Investment Review Agency,' available: <http://www.thecanadianencyclopedia.com/index.cfm?PgNm=TCE&Params=A1ARTA0002896>, accessed May 2007.

34 If the foreign bank chooses to open a branch they are either (as in the case of a 'lending' branch) not permitted to take deposits or (as in the case of a 'full-service' branch) permitted to take deposits greater than \$150,000. See, Department of Finance Canada, 'Glossary' Available: http://www.fin.gc.ca/gloss/gloss-f_e.html#forbrbank, Accessed May 2007.

35 For the foreign subsidiary, or a Schedule II bank or federally regulated foreign bank the rules are that, “Under this regime, banks with equity greater than \$5 billion are required to be widely held, with no person owning more than 20 per cent of voting shares or 30 per cent of non-voting shares. Banks with \$1 billion to \$5 billion in equity are allowed to be closely held, subject to a public float of 35 per cent of voting shares, while banks with less than \$1 billion in equity have no ownership restriction other than a fit and proper test”. See, Department of Finance Canada, 'Glossary' Available: http://www.fin.gc.ca/gloss/gloss-s_e.html#sched2, Accessed May 2007.

total banking assets in Canada)—not much compared to the \$1.1 trillion in assets of Canada's Big Five banks (86% of total assets).” The largest banks in Canada are Canadian. They provide the majority of the country's financial services and control 90% of total bank assets.³⁶ Conacher argues that because of this protection, Canadian banks do not face a perfectly competitive market and end up earning very high profits. His conclusion is since banks receive this protection they should be required to provide services to financially excluded people.

The level of foreign ownership in the fringe-banking sector varies. There is little evidence of significant foreign ownership in pawn broking or rent-to-own operations; however in the area of cheque-cashing/payday lending foreign ownership is significant. National Money Mart Inc., a subsidiary of U.S.-based Dollar Financial Group, had a large share of the payday lending and cheque-cashing market in Canada in the 1990s. Lott and Grant (2002, p.8) estimated that Money Mart had 60% of the Canada's cheque-cashing outlets. By 2004 its revenues were \$U.S. 85 million. In 2005 Rentcash Inc., through expansions and mergers, expanded to a similar size to Money Mart with its 2005 revenue amounting to \$77.3 million.

A careful review of the role of foreign investment in Canada's mainstream and fringe bank markets is needed to ensure

that net benefits accrue to Canadians. In addition, foreign investment review could include analysis of how different groups (for example, the financially excluded) within Canada are affected by the investment.

v) Facilitating savings & financial inclusion in welfare programs

In 2005, government welfare programs³⁷ in Canada provided support to 5% of Canada's population or 1.7 million people (National Council on Welfare, 2005). These programs are means-tested and generally require a person to run out of alternative income and exhaust their savings before receiving benefits. These programs provide very low levels of income, involve rapid claw back if a person moves to become independent, and disallow or discourage savings. These design features create disincentives for low-income people to become independent—employed, self-employed, independently retired—and financially included.

There is evidence that the value of welfare income has been stagnating, and in some cases, decreasing over the past twenty years. In 2005, it was found that welfare incomes in some locations and for some groups were lower than they had been in 1986 (National Council on Welfare, 2005). As a result, there is little, if any, extra income—rendering mainstream bank account-holding less useful.

36 Department of Finance Canada, 2001, 'Canada's Banks,' Available: http://www.fin.gc.ca/toce/2001/bank_e.html, Accessed May 2007.

37 Here, welfare programs refer to programs that provide financial assistance to an unemployed person who is without access to employment insurance or sufficient retirement income. The former is a provincial responsibility variously referred to as employment and income assistance, income assistance, Ontario Works, etc.. Another important program for this section is the Guaranteed Income Supplement, administered by the federal government and provides income to low-income senior citizens who receive Old Age Security. The National Child Benefit is another important federal welfare program.

Welfare programs are designed in such a way that rates and benefits drop precipitously if additional income (from employment or self-employment for instance) is earned. Income from work sources means that welfare benefits will be cut in the current period (in the case of a provincial welfare program) or in the future (in the case of the Guaranteed Income Supplement).³⁸ This dramatic drop in welfare benefits when a person begins to become independent creates what some have called a 'welfare wall' that actually blocks people from becoming independent (Battle and Torjman 1993, cited in TD Bank Financial Group 2005, 12). The welfare wall phenomenon is most comprehensively measured by the marginal effective tax rate, which is, "the sum of direct taxes and indirect taxes associated with the claw back of income-tested subsidies" (TD Bank Financial Group 2005, 9). For people receiving welfare, the marginal effective tax rate can be as high as 75% and spikes at 100% (TD Bank Financial Group 2005, 12). This means that for every additional dollar the person earns, for instance through a new job, 75¢ to one dollar is clawed back through higher taxes or foregone welfare income. Economically speaking, in the short-run, this person is better-off sticking to welfare.

Welfare programs often discourage, or fail to encourage, savings and banking. For instance, many welfare programs disallow or limit savings before entering or while a person is participating in welfare. In Manitoba, an Employment and Income Assistance (EIA) recipient must exhaust her savings before entering the

program. Once in the program, their savings is limited and, in some cases, welfare clients that we spoke with understood that any savings they accumulated would lead to a reduction in welfare benefits (Buckland *et al.*, 2003, 40).

By not encouraging savings and banking, welfare programs create an institutional barrier to financial inclusion. Welfare programs can be designed to encourage or discourage savings and banking in a number of ways. These characteristics, arising from the culture of the organization, include assumptions and expectations made by staff and participants about behaviour of participants. In some cases, this institutional culture within welfare programs can act as a barrier to people becoming independent. If staff assume and expect that participants are not interested or unable to save and bank then this assumption may become self-reinforcing.

Alternately, if welfare rules provide some options for saving and if staff encourage savings and use of bank accounts, then clients would be more likely to achieve financial inclusion and independence. For instance, in an asset-building program,³⁹ such as the Learnsave program, which is a pilot project operating in several cities in Canada, participants' savings are matched and earmarked for further education or starting a business. Participants are required to have (or open) a bank account and are encouraged to regularly save. If this type of dynamic could be introduced into welfare programs, at least for some participants, then savings and financial inclusion could be encouraged and this could be a step towards independence.

38 In the case of the guaranteed income supplement (GIS), retirement income from personal savings reduces future GIS payments.

39 Since asset-building programs are voluntary this example is not completely transferable to welfare programs.

In Manitoba, EIA clients can either open an account for direct deposit of benefits or they can receive them by cheque. Alberta is piloting a program where welfare payments are loaded onto a debit card. These options might be a start towards financial inclusion, but will ultimately need to be combined with other benefits for effective financial inclusion.

Welfare programs need to be designed to enable people to become more independent.⁴⁰ This can be done by increasing the welfare rates, reducing the claw back and encouraging recipients to become banked. Since low welfare rates reduce the benefits of financial inclusion, one clear way to promote inclusion would be to increase the rates. In addition, it would be useful to develop, in conjunction with community agencies and banks, optional programs that encourage and facilitate savings.

b) Government service provision

i) Provision of financial services

In some countries, government agencies provide financial services. A notable example of this is the U.K. where such services are provided through the post office. The post office system in the U.K. has 19,000 outlets and presence in many low-income communities.⁴¹ The U.K. Financial Services Authority concluded,

It is generally accepted that expanding the role of the Post Office will

help tackle both financial and social exclusion. Not only will it increase access to financial services, but it will safeguard local post offices, and the shops in which many are based, in communities that, otherwise, have very few services within them.⁴²

Since many post office outlets in Canada have been franchised to private companies this option may not be as attractive here as it is in the U.K. Private ownership may make it more difficult to include financial services. Also, the location of the outlets may not cover underserved inner-city and isolated rural locations. In addition, training of staff on the particular financial service needs of low-income people may be more difficult with franchises.

ii) Provision of education on financial management

With the growing individualization of the economy and society, education about personal financial strategy and services is of increasing importance. With declining government and employer participation in retirement schemes, Canadians increasingly rely on personal decision-making and personal savings for retirement. The possibility of further privatization of health care is a further reason for Canadians to have improved knowledge of financial strategies and services. The fact that non-mortgage consumer debt in Canada is at record levels is another indicator that financial education should be enhanced.

40 A helpful way to think about this is the program has to minimize its costs while ensuring income security for vulnerable people. "Ultimately, the design of such programs comes down to an exercise in tinkering with the balance between these competing objectives" (TD Bank Financial Group, 2005).

41 Financial Services Authority *In or out? Financial exclusion: a literature and research review*. 2000, p.80.

42 Financial Services Authority *In or out? Financial exclusion: a literature and research review*. 2000, p.80.

A strategy that fosters knowledge of financial options and encourages people to apply these options to make decisions that improve their financial and overall well-being is needed. This would involve educational institutions, government agencies, banks and community organizations. The federal government has initiated work in this area (SEDI, 2004).

One component of financial education is education on the relationship between life goals, financial goals and financial services. This knowledge would allow the consumer to better select financial services associated with particular financial and life goals. In several countries, a government agency (the Financial Consumer Agency of Canada, U.K.'s Financial Services Authority) is charged with promoting consumer knowledge about financial services. The FCAC provides literature on various types of financial services (for example, credit cards, payday loans) through its website and public events (for example, the Canada Pavilion). While the FCAC's resources are limited (it relies for its funding from a bank levy), the 2007 federal budget provided \$3-million to the FCAC to promote financial literacy among youth and investors.

In providing financial information to low-income Canadians, the FCAC must recognize that many low-income Canadians are not aware of the FCAC and do not own a computer or Internet hook-

up to access its materials. Furthermore, the FCAC has not developed materials on some sensitive financial services such as pawn broking and cheque-cashing.

iii) Universal personal identification

Many low-income people have trouble getting and maintaining the personal identification needed to use bank services, particularly photo identification (ID). For example, the \$30-\$50 annual fee in Manitoba needed to maintain a driver's license may be prohibitive for a low-income person.

In response, government could establish a photo ID system for low-income people that could be used for banking purposes. In Manitoba, for example, the Manitoba Liquor Control Commission provides a low-cost photo ID (\$17) that can be used at some financial institutions. This card can only be obtained at one location in Winnipeg and then only after the applicant provides three pieces of identification. If the card were easier to obtain, it might be more commonly used by low-income people. Alternatively, the government could support the efforts of financial institutions and community agencies to create photo ID systems that meet federal security requirements. Some fringe banks (Money Mart) and special outlets (Winnipeg's CFSC) have introduced their own photo-ID system.

IV) Summary and Discussion

This report has identified ways in which banking services and government policies might be reformed to promote financial inclusion. Some of these reforms to services/service provision and policies are more practical than others. Some banking changes involve adding a new service, while others involve changing banks at a more cultural level. Establishing more inner-city branches, new savings and credit schemes, and establishing universal photo ID are new services that are useful. Other banking changes require a cultural change such as providing more information about services and promoting more respectful and trusting relations with low-income clients. Greater financial inclusion will require both more services and cultural change. If banks were to agree to adopt new identification requirements for opening accounts and cashing cheques it would be an improvement in service, but it would not, for many low-income people, sufficiently increase the net benefits of becoming banked. New services for and new attitudes about low-income people are needed.

Some of the suggested government policy initiatives, such as boosting consumer protection, are more consistent with current political-ideological views and some, such as carefully reviewing foreign investment in banking, are less. This suggests that some policies have a greater likelihood of being adopted than

others. These reforms will require cooperation among mainstream and fringe banks, government and community organizations. Key reforms would address the following:

- Governments must strengthen regulation and/or support for banks and community organizations that provide access to basic banking
- Governments need to work harder at protecting the vulnerable consumer, to start with by integrating the vulnerable consumer notion into financial consumer protection
- The federal government needs to ensure the financial service market is competitive and benefiting Canadians. Competition needs to exist at various levels, including within particular vulnerable geographies. Foreign investment needs to benefit Canadians
- Governments could raise welfare rates and reform welfare policy so that savings, financial inclusion, and independence are encouraged
- Governments, along with banks and community organizations, need to provide financial education
- Governments could provide or support organizations that are providing personal identification.

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