



# CU Impact: Technology Solution for the Large-Scale Delivery of Safe, Responsible Financial Products in Low-Income Communities

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## Introduction

When it comes to money, most people make choices based on trust and convenience. This is especially true for those who are the most economically insecure, where financial choices can affect a family's health, well-being and prospects for stability. Unfortunately, families and individuals with the least money often have the fewest choices, with little or no access to safe and affordable products and services. These economically vulnerable Americans rely upon payday lenders, check cashers and other fringe financial services that charge exorbitant interest and fees for essential small dollar credit products and transaction services. Despite regulatory efforts to protect consumers, the fringe financial sector continues to thrive. Low-income consumers need more than just protection; they need real choice.

Historically efforts to expand services in low-income communities have focused on brick and mortar branches. But in recent years, studies into the needs and preferences of low-income people have indicated the mismatch in consumer needs with the right products and services plays a much greater role in keeping many outside the financial mainstream.

For nearly a century, *community development* credit unions have delivered safe and affordable financial products and services in the nation's most economically disadvantaged communities; targeting unbanked and underbanked consumers. Responsible products and services have earned the trust of low-income consumers, but community development credit unions have thus far been unable to supply these services at a scale to match the magnitude of demand.

While community development credit unions have proven to be leading innovators and early adopters of new technologies<sup>1</sup>, their growth is constrained by the cost and complexity of connecting innovative products and services to their banking platforms. This Paper describes how *CU Impact*, a customized shared banking system, will help to scale up the delivery innovative products and services in low-income and underserved communities. *CU Impact* will provide a robust technological platform to accommodate ongoing innovation, facilitate collaboration and generate growth, visibility and ultimately impact in underserved communities. With generous support and thought leadership from Citi Community Development, the Federation has elaborated a vision for *CU Impact* to fundamentally transform the way in which credit unions deliver financial services on a large scale at low cost, sustainably, and without losing the hard-earned trust of low-income consumers.

*CU Impact research and design is made possible by a generous grant from Citi Community Development*

Community Development



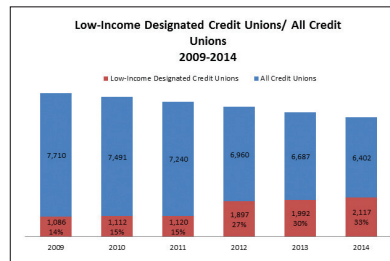
## Dimensions of the Challenge

Financial vulnerability is not limited to the world’s poorest people or nations. Despite the United States’ relative wealth, tens of millions of Americans are financially insecure, lacking either the ability to meet monthly bills or the necessary savings to cover unexpected expenses. According to a 2013 study by the FINRA Investor Education Foundation, more than half of Americans lack sufficient savings to cover three months of living expenses if an unexpected need arose in the following month.<sup>2</sup> Recent research confirms that communities of color suffer most, with racial wealth gaps growing wider since the recession.

For economically vulnerable Americans, particularly Latino and African American households, financial insecurity is compounded by a lack of access to secure, affordable financial services. One quarter of all U.S. households do not have a basic checking or savings account or rely on fringe financial services for banking needs. The average underserved household spends \$2,412 each year just on interest and fees for fringe financial services, and in 2012, these charges drained nearly \$90 billion from low income households.<sup>3</sup> High interest rates and excessive fees can be especially detrimental to low- and moderate-income families who struggle to cover basic needs.

## Growth in Products, Services and Impact

For nearly a century, the credit union movement has operated with the explicit goal of serving “people of modest means.” For much of this time, a small but growing number of credit unions have specifically focused on the most underserved communities where few good options could be found. In 1974 these credit unions came together under the banner of *community development* credit unions or “CDCUs” joined by their common mission. In the 1990s these credit unions were recognized by the U.S. Treasury Department as part of a new industry of “Community Development Financial Institutions” or “CDFIs.”<sup>4</sup>



Recent research has found that the CDFI industry actively delivers on its promise to direct financing to borrowers from targeted historically underserved. A study by the Carsey Institute at Southern New Hampshire University found that the CDFI industry – and particularly CDFI credit unions – have “grown substantially, leveraging investment and growing its lending activity, even in the face of the recession and cataclysmic changes in the financial environment.”<sup>5</sup>

During the height of the recession and its aftermath, CDFI credit unions expanded significantly in people served, service offerings and loans made. From June 2009 to June 2015, the number of CDFI credit union branches operating in CDFI Investment Areas more than tripled, from 207 to 709, and the number of members served by CDFI credit unions grew from just over 600,000 to more than 4 million.<sup>6</sup> This growth would not be possible without targeted investment and an aggressive application of advanced member service technologies. A 2014 review of the impact of investment on credit unions found that CDFI credit unions increased the number of branches at a greater rate than their peers, providing millions of consumers with access to safe, affordable financial products and services.<sup>7</sup> Although the CDFI sector remains very small in relation to mainstream financial institutions, as noted in the Carsey study, the rapidly expanding reach of CDFI credit unions points to a unique opportunity to “democratize” the financial services marketplace for disenfranchised consumers.

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## Technology as the Pathway to Achieving Scale

New technologies offer community development financial institutions the opportunity to increase the scale of product and service delivery, reach more underserved people and make a greater impact in their communities. While credit unions have not historically been known for speed and rapid adoption of new technology. New technologies are reinventing the manner in which small institutions can serve their members more effectively while delivering greater convenience and real-time access to their accounts through online banking and mobile apps. By aggregating purchasing power of small institutions, there is a tremendous opportunity to poise these small institutions to leap forward with far greater reach and services than previously possible. But investment must be strategic and focused on laying the proper foundation for multiple small players to tap.

In recent years, philanthropic and socially responsible investors have targeted a range of new products and new technologies that promise to deliver better, safer products to lower-income individuals and families. Many of these product innovations are intended to encourage the broader financial services industry to embrace pro-consumer features. CDFI credit unions are ideal vehicles to deliver these innovations to underserved markets because: (i) delivery aligns with their mission of community development; (ii) they are present and trusted in these communities; and, (iii) they have a demonstrated commitment to test and implement new solutions. However, the high cost of integrating each new innovation into legacy core banking systems inhibits the spread of new products and services. The challenge is clear: how to create the right efficiencies to grow and expand while continuing to offer products and services to small accountholders in a trusted, responsible and affordable manner.

For financial institutions, the core banking system is the foundation upon which all innovation is built and must be able to connect. As innovation and change continue to happen at a rapid pace, *community development* credit unions need solutions that can enable them to continue to provide high-touch services without sacrificing speed and efficiency.

## The Vision: A New Foundation for Cooperative Banking

A new common banking platform will enable mission-driven financial institutions, like CDFI credit unions, to reach new populations, design and implement new asset building products, establish greater efficiencies, coordinate investment and dramatically increase their capacity to serve the many millions of Americans who remain outside the financial mainstream.

The Carsey Institute reports that among CDFI credit unions and banks, operating expense is consistently a more powerful driver of profitability than loan performance or cost of capital.<sup>8</sup> The paper concludes that “factors driving CDFI operating expenses are clearly complex, but the bottom line is that more efficient delivery mechanisms may be critical for CDFIs’ survival. These mechanisms could include greater use of technology, more collaboration between organizations, and expanding overall assets so that fixed costs are spread over a larger asset base.”

Collaboration is not unique to CDFIs, nor is it a new way to scale an industry. One of the most well-known and successful examples in the financial services industry came from the for-profit banking world; the Visa network, the world’s most widely accepted payment system for consumers and businesses. The very first credit cards enabled bank customers to access small lines of credit at the point of purchase, but relied upon considerable coordination between retailers and banks in local and then regional markets. As demand increased to use

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these cards across larger areas and outside a single bank's footprint, a new system was needed to link multiple banks, merchants and consumers. As described in a 2003 case study by Ratliff and Moy, the pioneering BankAmericard was initially limited to Bank of America's footprint in California, but soon grew beyond the region through a series of agreements with banks across the country, licensing the banks to issue the card.<sup>9</sup> In order to expand the market for the product and reach scale, participating banks formed a jointly owned company to license access to the system and thus established the Visa network with collaborative control and oversight. This resilient structure, which depends on a robust technological platform, led to dramatic growth of consumer lending through a credit card industry.

Credit unions are organized as cooperative financial institutions and have a long history of cooperation to grow and expand services. Credit union service organizations (CUSOs) are businesses owned, often cooperatively by multiple credit unions, which purchase shares and deliver services more efficiently. These businesses provide economies of scale through back-office functions or the outsourcing of specialized services such as business or mortgage lending. In Canada, the Desjardins Group enables hundreds of small credit unions to share back-office and standardized systems and deliver credit union services to almost 6 million Canadians, primarily in Quebec. Cooperative banks in the Northern Italian region of Trentino use a cooperative banking model that dates back to the 1950s where a central back-office institution serves hundreds of small, local banks and has efficiently driven the economic engine of this successful region into the 21st century. Dedagroup SpA, which powers the banking system used by Trentino's cooperative banks, has since expanded its model to Eastern Europe and most recently Mexico.

## A US Collaborative Banking Infrastructure for Low-Income Communities

More than a decade ago, the Federation outlined three major pathways for credit unions to grow and achieve scale through collaboration: (i) merge with other like-minded institutions; (ii) rely upon "Angel" high-capacity credit unions to power back-office functions and support; or, (iii) aggregate multiple smaller and mid-size credit unions to create back-office support system to facilitate growth, aggregate purchasing power, reduce cost and foster more rapid adoption of new technology and product innovation. Since that time, the Federation has tracked, promoted and supported model collaborative efforts among its members to identify the most successful pathways. Lessons learned include:

1. Successful collaboration among multiple small parties requires not just alignment of mission but a shared vision of the pathway to achieve scale.
2. There must be clear leadership to set the course and steer the process.
3. Diversity in size and capacity among partners is essential; solutions exclusively for small institutions cannot and will not succeed.
4. The "Angel" case in which a large institution adopts a small or start-up venture is extremely rare, often dependent on unique circumstances and generally is very difficult to replicate.

In 2011-2012, Federation staff and members visited Trentino and Mexico to learn more about the cooperative bank model and the system that has powered its growth. In 2013, with generous support and strategic input from Citi Community Development, the Federation

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embarked upon a research and design project to determine the feasibility of building a dedicated core banking system to power the growth and impact of CDFI credit unions in the United States. As part of this process, the Federation convened a Technology Advisory Committee to delineate the essential elements of an ideal core operating system with specific capabilities for *community development* credit unions.<sup>10</sup> The study analyzed both the supply of data processing companies currently working with credit unions and the demand among credit unions across a wide spectrum of size and capacity. The final study included the following key findings:

- 1. Existing system or provider do not cater to the unique needs of credit unions that serve predominantly low-income communities.** The limitations of existing core systems inhibits innovation in products and services needed to efficiently serve the high-transaction and flexible credit needs of low-income and very low-income consumers. As a result, CDFI credit unions that serve these communities can only innovate at high cost, paying to adapt new products and services to inflexible data processing systems. Existing software providers have not tailored their systems to accommodate low-income account holders. Existing systems also do not allow CDFI credit unions to track data related to community development outcomes and impact, which is critical for fundraising, advocacy, reporting and compliance.
- 2. The use of different core data processing systems inhibits the national rollout of innovative products and services.** Currently, credit unions innovate through individual experimentation, documentation and communication of best practices. Each credit union that wishes to adopt a promising product or service must pay for its own customized solution to graft a new innovation onto its core data system, which adds costs, reduces efficiency and limits the ability of the industry to deliver standard products and services across multiple geographies and communities. Smaller credit unions are often unable to deliver the innovations at all because they do not have the market share to entice their software provider to work with them on adapting or modifying their core systems.
- 3. The cost of basic core data systems is disproportionately high for community development credit unions.** Community development financial institutions often overpay for technology that should be decreasing over time because they cater to low-income people with small account balances. Market pricing structures disadvantage institutions with high concentrations of small account balances. The Federation study found that core banking technology is the second largest expense for all credit unions, behind labor; for small credit unions, core technology expense even exceeds the cost of labor. While technology costs in most industries are decreasing, the credit union movement faces ever increasing expenses for their core data systems. Small and mid-sized credit unions simply cannot afford to pay more.
- 4. Most core data processing systems are old and in need of an update.** “Many of the antiquated [banking] systems currently in place were built 20-30 years ago on technology that was current at the time, but now lack many of the sophisticated functionalities that are available today.”<sup>11</sup> Smaller financial institutions face the most significant challenges and costs to adapt or upgrade antiquated legacy systems. Four large companies control 86% of the core banking system marketplace for all credit unions, and two of these large players dominate 70% of the marketplace for smaller financial institutions. These companies are not oriented toward the needs of smaller financial institutions or the delivery of products to low-income consumers. The remainder of the market is served by a few dozen small players with varying capacity and limited R&D budgets that prevent rapid introduction or development of new or upgraded software. Due to their limited resources, these companies

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give priority to regulatory compliance and systems maintenance over innovation in products and services. Overall, the market is ripe for the entry of a provider can offer an updated, flexible and efficient core data system and support new financial products and services – and track the community development indicators – for CDFI credit unions of all sizes.

## Scale and Impact in 2015: the Pathway for Community Development Credit Unions

To maximize efficiency, any core banking solution that enables small credit unions to consolidate back-office processing must also be suitable for larger institutions. For larger CDFI credit unions, a new system must offer three key advantages: (i) speed and flexibility in rolling-out innovative products and services; (ii) the ability to rapidly and efficiently extend successful product and service innovations to multiple institutions with consistent features; and, (iii) integrated tracking of data required for reporting on community development outcomes and impact.

Due to the high compliance and regulatory burdens of the US financial services marketplace, the risk involved with start-up ventures and the concern of mission shift involved with a tech start-up; the Federation Board and leadership determined that the best course of action was to adapt an existing system through a partnership with a mission-aligned company. Following a review of the cooperative banking models in Italy and Mexico, the Federation intensified discussions with Dedagroup, to explore how the software capacity of their “Bank Up” system might be combined with the programming, operational capacity and salesforce of an existing US software company. Dedagroup identified EPL as a strong foundation for the development of an American core banking processing system that would be comparable to both the Desjardins model in Canada and the Trentino cooperative banking platform in Italy. EPL, a CUSO in Birmingham, Alabama, is best known for its pioneering IPower system, which has long been recognized by users for its modern platform, its ability to integrate easily with third parties and flexibility. In March 2015, Dedagroup purchased EPL.

The Federation, Dedagroup and EPL are now working together to build *CU Impact*, a core banking system designed specifically for CDFI credit unions. Drawing on the Federation’s leadership, experience and knowledge of underserved markets, the partners plan to develop *CU Impact* with the capacity to integrate new products and services targeted for low-income and underserved consumers, track outcomes, and support the consolidation of accounting, compliance and processing functions for credit unions of all sizes. The platform will be built on the key principles that facilitate economies of scale for small cooperative banks inspired by Desjardins and the Trentino model, allowing numerous small institutions to connect to coordinated, aggregated banking services with consolidated back office accounting, processing and compliance functions.

*CU Impact* will have four central goals:

1. **Facilitate development and deployment of new products:** The Federation will identify new products and services to be integrated into the system. These include: remote account opening to facilitate recruitment and enrollment from community partners; money management tools integrated into transaction accounts; national savings and asset products such as child savings accounts; transparent and trustworthy remittance services; and consumer lending and small dollar loans, among others.

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2. **Measure and evaluate community development impact.** The system will provide credit unions with tools to extract and analyze data to track progress of members over time through the credit union, including changes in member credit scores and linkages to key community development goals and performance metrics. The Federation will work with CDFI Fund and other investors to facilitate transfer of data into key reporting functions such as the CDFI Fund's CIIS, AMIS and other reporting and financial counseling and coaching data systems.
3. **Increase efficiency and lower the cost to credit unions:** *CU Impact* will lower operating costs by offering credit unions a system that: bundles together a number of key applications that represent expensive add-ons for other core systems; operates on a modern relational database for efficient storing and sharing of information; and, creates economies of scale by switching the credit union's IT operations from in-house management to an outsourced Application Service Provider (ASP) outsourced ("resource sharing") model.
4. **Connect and 'play well' with other systems with an integrated solution:** To grow services and reach into new markets, *CU Impact* will provide a seamless process to add products and services. New technologies and tools, oftentimes connected from external parties, offer these institutions the opportunity to transform their operations and reach a far greater scale.

Ultimately, *CU Impact* will:

- Connect more low-income Americans to safe and affordable credit union services;
- Provide a uniform platform for low-income consumers to access consistently high quality products and services across a diverse range of credit unions, whether they operate from a credit union branch, a church basement or a social service organization;
- Develop a continuum of asset-building accounts, loans and education to help people move from debtor to saver to asset owner; and,
- Provide the Federation with an engine to help reverse the troubling trend of diminishing small and minority credit unions that tend to serve very hard to reach and underserved communities.

*CU Impact* will have far greater capacity to design, develop and roll-out innovation in payment and transactional services to keep pace with rapid shifts in technology and access. Unlike other core systems, *CU Impact* will prioritize adaptations and enhancements that promote financial inclusion to untapped markets including underbanked adults, immigrant populations and others and provide integrated tools to track, measure and analyze data on member outcomes and impact. These key capabilities will enable *CU Impact* to transform the CDFI credit union industry from a collection of individual, hard-working boats into a unified fleet powered by a common engine.

This unprecedented capacity for collaboration, innovation and efficiency will help CDFI credit unions chart a new course to scale in the delivery of responsible, affordable products and services in low-income and underserved communities.

<sup>1</sup> Terry Ratigan, National Federation of Community Development Credit Unions, "CDFI Certification: A Building Block for Credit Union Growth; Performance, Profiles and Prospects for CDFI Credit Unions, White Paper commissioned by CUNA Community Credit Union Committee, 2014

<sup>2</sup> Annamaria Lusardi, "Americans' Financial Capability," National Bureau of Economic Research, NBER Working Paper No. 17103 cited in Gary Motolla, "Softening the Blow: Income Shocks, Mortgage Payments and Emergency Savings," FINRA Investor Education Foundation, March 2013;

<sup>3</sup> "Providing Non-Bank Financial Services for the Underserved," White Paper, Office of the Inspector General, United States Postal Service, January 2014.

<sup>4</sup> The U.S. Treasury Community Development Financial Institutions Fund certifies community development banks, credit unions, loan funds and venture capital funds that meet seven specific criteria, which show a primary mission of community development and predominant services in low-income and underserved target markets. CDCUs include all credit unions that have received or are eligible for CDFI certification. In this paper, "CDFI credit unions," "community development credit unions" and "CDCUs" include all credit unions that are CDFI certified or eligible for certification.

<sup>5</sup> Michael Swack, Eric Hangen, Jack Northrup, "CDFIs Stepping Into the Breach: An Impact Evaluation – Summary Report," Carsey Institute of Public Policy, University of New Hampshire. August 2014.

<sup>6</sup> Terry Ratigan, "Trends in CDFI Credit Union Services, 2009-2015, An Analysis of Data from CDFI and NCUA Data," Report to the National Federation of Community Development Credit Unions, July 2015.

<sup>7</sup> Ibid.

<sup>8</sup> Swack, Hangen, Northrup, 2014 op. cit.

<sup>9</sup> Gregory A. Ratliff and Kirsten S. Moy, "New Pathways to Scale for Community Development Finance," with Laura Casoni, Steve Davidson, Cathie Mahon, and Fred Mendez, The Aspen Institute, 2003.

<sup>10</sup> The Technology Advisory Committee consisted of IT Directors and CEOs from leading CDFI credit union innovators including: ASI FCU (chair), Guadalupe CU, Missoula FCU, Self-Help CU, Lower East Side Peoples FCU and Neighborhood Trust FCU.

<sup>11</sup> Oracle Financial Services White Paper, January 2009