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Executive Summary

Many financial institutions elect not to provide credit to consumers with damaged or insufficient credit history, believing the risk these consumers pose to the institution outweighs the potential benefits of serving them. This mindset is potentially detrimental to consumers, who may be inadvertently subjected to harm when they are forced to rely upon low-quality credit products, and to providers themselves, who miss out on real profit opportunities as well as the potential to develop loyal and long-term customer relationships.

Banks and credit unions can and should be doing much more to support consumer credit building – and, more importantly, they can do so in ways that align their own success with the success of their customers. With few large-scale consumer credit building solutions existing today, banks and credit unions have a critical role to play in bringing scale to the innovative solutions that do exist but that are not yet widely available to consumers. In this paper, we suggest a number of initiatives that banks and credit unions can undertake to help build the credit profiles of low and moderate income consumers. We offer initiatives that can be implemented in the short-term, medium-term, and longer-term, with the short-term solutions being the least labor and cost-intensive, and the longer-term solutions requiring a more significant effort on the part of individual financial institutions as well as more systemic, industry-wide change.

Strategies for Banks and Credit Unions to Support Credit Building:

Short-term – Credit Building Tools, Services and Partnerships:
- Connect customers to online and mobile-enabled credit score tracking tools
- Connect customers to personal financial management (PFM) tools, or build in-house PFM tools
- Partner with non-profits to offer high-touch products and services
- Connect customers to online and offline debt management programs

Medium-term – Risk-Limited, Credit Building Products:
- Develop and market secured credit products or credit builder loans
- Develop and market low credit lines
- Offer loan terms that improve with good behavior
- Invest in marketing efforts for credit building products

Longer-term – Go Beyond Traditional Credit Files:
- Consider New and Deeper Sources of Data for Credit Decisioning

Consumers approach banks and credit unions in search of an appropriate small-dollar credit product every day, and in some cases, these consumers do not qualify for the product they are seeking. However, consumers should never have to leave a financial institution completely empty-handed and without any knowledge of how to improve their credit standing. No matter the level of time and resources banks and credit unions are able to devote to customer credit building initiatives, there are a number of ways for financial institutions to help customers. Those institutions that do so will derive significant long-term benefits in customer loyalty and retention, and also uncover new potential revenue sources.
Consider a customer who approaches a bank or credit union seeking a small-dollar credit product. The customer is run through the traditional credit checks and found to be ineligible for the product that he or she applied for. The issue may be a thin credit file or no credit file, damaged credit from past mistakes, over-indebtedness, or a number of other reasons. What happens next? Is the customer turned away for good? Offered guidance on steps to improve his or her credit profile and invited to come back at a later time? Or does the financial provider use the opportunity to build a relationship with the customer, offering smartly designed tools and products that can help build or rebuild the customer’s credit standing?

Many financial institutions – particularly today, post-credit crisis – send the customer away, fearful that forming a relationship will impose too much risk on the institution or the customer. However, in so doing, these providers may be indirectly putting customers in harm’s way by driving them to lower-quality credit options, and also unnecessarily reducing their potential customer base. Banks and credit unions are, in fact, well positioned to help consumers build their credit profiles and gain access to well-structured credit. Those institutions that do so will derive significant long-term benefits in customer loyalty and retention, and also uncover new potential revenue sources.

Access to high-quality credit is critically important for low- and moderate-income (LMI) consumers. Having the ability to borrow money, under reasonable terms, can support longer-term household savings and facilitate purchases that can contribute to other wealth-building activities. High-quality forms of small-dollar, short-term credit can also help LMI individuals weather financial shocks. Having access to credit under the best terms is closely linked to having a strong credit score, and millions of consumers have seen their credit scores decline after having become over-indebted in the wake of the financial crisis. What’s more, as many as 70 million Americans are unable to qualify for high-quality credit, partially as a result of an insufficiently documented credit history. As a result, these consumers are limited to expensive and often predatory credit products, which diminish, rather than augment, assets.

For financial institutions, extending credit carries risk, and banks and credit unions use credit scores provided by the “Big Three” credit bureaus (Experian, Equifax and TransUnion) to help manage that risk. Statistically, borrowers with lower credit scores are more likely to default, so lending to consumers in the lower credit tiers increases the risk to the lender. However, scores provided by the bureaus only tell part of the story. Many consumers in the U.S. are prevented from accessing well-structured forms of credit because there is either a lack of evidence within the mainstream credit reporting system about their repayment behavior, or the evidence contained within the system paints a one-dimensional picture that does not tell the full story about the consumer. The consequence for consumers is lack of access to quality credit. For financial institutions that turn away consumers who are capable of responsibly paying back credit, the consequence is a missed opportunity to profitably serve more customers. In fact, recent consumer research conducted by CFSI found that consumers who do not use or have access to traditional credit products, such as unsecured credit cards, are more likely to use small-dollar credit instruments: among small-dollar credit users, only 27% reported having a credit card, compared to 61% of non-small-dollar credit users. This finding suggests...
that not having access to traditional credit may be a key factor in leading a consumer to products such as payday, pawn, and auto title loans.

Financial institutions can and should play an active role in helping U.S. consumers improve their credit standing. With the Dodd-Frank Wall Street Reform and Consumer Protection Act imposing new requirements on how to communicate with customers in adverse action or risk-based pricing scenarios, now is a particularly opportune time for banks and credit unions to rethink their existing credit building initiatives and/or to develop new initiatives. Whether through improved disclosures, third-party referrals to debt management programs, product development and promotion, or enhanced analytics, there are many ways financial institutions can help consumers, while also effectively managing the risk of broadening their lending portfolios.

In this research paper, we describe initiatives that can be implemented over the short-term, medium-term and longer-term, and the initiatives are described in order of increasing complexity. However, the short-term initiatives need not necessarily be implemented before taking on the medium- and longer-term initiatives. Financial providers should consider which of the suggested initiatives best align with their own strategies and use that analysis to guide their approach to developing credit building initiatives for their customers.

CFSI’s Compass Principles

An underlying theme of all of the recommendations that follow is that, for solutions to be sustainable – and thus available to consumers in an ongoing fashion – they must be both profitable and scalable for financial institutions. Profitability and scalability are among the six core values of CFSI’s Compass Principles, which describe an aspirational vision for a future in which financial services are safe and actively contribute to improving people’s lives. The Principles themselves also underpin the recommendations contained in this paper. Outlined below, the Compass Principles provide a clear set of guidelines for financial providers who share CFSI’s vision for a future in which financial services actively contribute to making consumers’ lives better, and deliver sustainable value to all providers and consumers.

• Embrace Inclusion: Responsibly Expand Access
• Build Trust: Develop Mutually Beneficial Products that Deliver Clear and Consistent Value
• Promote Success: Drive Positive Consumer Behavior through Smart Design and Communications
• Create Opportunity: Provide Options for Upward Mobility

For more information on the Compass Principles, visit www.compassprinciples.com.

Key Stats*

- 70 million Americans have a thin file or no credit file
- 144 million U.S. consumers are over indebted
- 25% of small-dollar credit users don’t know their credit score
- 56% of consumers say they need help improving their credit score
- 46% of thin file consumers were found to have prime or superprime scores
- People who use small-dollar credit products like payday and pawn are less than half as likely to have a credit card as people who don’t

*See text for full citation
Part 1: Background

**SETTING THE STAGE: CREDIT SCORES TODAY**

A person’s credit score, credit profile, or credit standing all generally refer to the numerical score and historical payment and account information that are contained within the databases of the three large credit bureaus (Equifax, Experian and TransUnion), and in turn within the credit reports that the bureaus generate. There are two dominant scoring models that are used to assess U.S. consumers’ creditworthiness on the basis of their past repayment and account maintenance behaviors: FICO and VantageScore. All three of the major bureaus report consumer credit scores under both models, and lenders purchase these scores from the bureaus and then incorporate the scores into their underwriting models.

Lenders then use these “generic” scores provided by the bureaus in one of three ways: (1) they use the credit scores exactly as provided by the bureaus, (2) they incorporate the bureaus’ scores into their own internal scoring models, or (3) they incorporate the data collected by the bureaus (as opposed to the resulting scores) and use that data in their own internal models. As a result, there is no single credit score or report that defines the creditworthiness of a consumer. In fact, lenders use and create countless variations of credit scores, which increases the complexity of the system and makes it even more difficult for consumers to understand exactly how their access to credit products is affected by these inputs.

Credit scoring systems measure relative risk across the total population, so while the proportion of consumers in each of the different credit tiers (i.e., super prime, prime, near prime, subprime) remains relatively constant over time, the number of defaults and delinquencies in each score band can shift significantly. In other words, while approximately the same number of consumers will have a particular credit score at any given time, the risk posed by a consumer with that score will be higher or lower based on the overall risk in the population. For example, the probability of being 90-days past due on a mortgage for consumers with a VantageScore of 700 was below 2% in 2005, rose to around 7% in 2009, and was back down to around 2.5% in 2011.²

In the immediate wake of the financial crisis, many consumers’ credit scores migrated up or down the score spectrum. Of consumers who were considered super prime in 2007 (VantageScore of 900+), more than a third were prime or lower in 2011. Among those who were prime in 2007 (VantageScore 701-900), about the same percentage moved up to super prime (13%) as moved down to a lower credit tier (16%). Finally, those consumers who were categorized as near prime in 2007 were most mobile, with 30% shifting to subprime and 39% migrating up to prime by 2011.⁴
While the overall picture is mixed between consumers gaining more control over their finances and those finding themselves more strapped than ever before, it is clear that a substantial number of U.S. consumers have found themselves newly in the lower scoring tiers of the credit spectrum in recent years, whether through their own actions or through systematic adjustments to credit standards. These consumers may find that, for them, high-quality credit is expensive or inaccessible. Further, credit reports, as generated by the bureaus, are increasingly used in areas outside of the credit system, including for evaluating renters and job applicants, meaning that any derogatory information appearing on the credit report can impact consumers’ lives beyond their access to credit.

In addition to the millions of consumers who have lower credit scores as a result of the financial crisis, tens of millions more have remained largely outside of the credit scoring system, which impacts their ability to get credit as well as their ability to access the other opportunities for which credit scores are used. As many as 70 million consumers in the U.S. have thin or no credit files, meaning that there is little or no information in the traditional bureau system to document their repayment behaviors. When it comes to accessing high-quality credit products, these consumers face the conundrum that it takes a credit score to be able to borrow from lenders, and yet it is impossible to develop a credit score without using credit products that get reported into the system.

Some lenders have begun to incorporate alternative forms of credit data into their scoring models in order to capture a wider swath of potential borrowers and in order to better evaluate the risk posed by individual borrowers. There are some limitations imposed by the Fair Credit Reporting Act (FCRA) on exactly what types of data can be collected, disseminated, and used. Financial institutions are prohibited from using data that is not compliant, and banks and credit unions are often cautious in the adoption of new forms of data, in their desire to avoid a violation of fair lending laws. However, a number of companies currently offer non-traditional forms of data for sale to lenders, and many more are testing new data for predictiveness. (See section “Longer-Term Recommendations: Go Beyond Traditional Credit Files” for a deeper analysis of this trend.)

Most industry experts agree that consumers’ general level of understanding about the credit reporting system has increased in recent years, thanks to the broad commercialization of websites like www.freecreditreport.com. A second annual field study conducted by the Consumer Federation of America and VantageScore in early 2012 found that consumers’ level of understanding about credit scores improved significantly between 2011 and 2012. Consumers’ level of awareness about who collects credit scoring information, what constitutes a strong score, and how to raise a credit score increased significantly over 2011 levels. However, a knowledge gap remained about the financial cost of a poor score and about exactly what is measured by a credit score. CFSI’s own research on users of small-dollar credit has revealed that 25% of these consumers don’t know their own credit score. In addition, a recent poll conducted by the National Foundation for Credit Counseling found that 56% of consumers identified “improving my credit score” as the area in which they needed the most help within personal finance. Facilitating increased consumer knowledge about credit scores and how they lead to better access to high-quality credit vehicles – and more importantly, facilitating
this knowledge gain at the right times and in the right ways – has enormous value, and financial providers have an important role to play.

**DODD-FRANK AND CREDIT SCORE DISCLOSURES**

There are several regulatory requirements that dictate the ways in which financial institutions share information related to credit scoring with customers. In particular, the Fair and Accurate Credit Transactions Act of 2003 put in place the requirement that consumers get access to one free credit report per year, the fraud alert provision (requiring specific actions from financial institutions when a customer believes he or she has been a victim of fraud), and disclosures related to consumer rights when it comes to identity theft.

However, recent changes under the Dodd-Frank Wall Street Reform and Consumer Protection Act may provide a new impetus for financial institutions to change their approach when they communicate to customers about credit scores. Going back to the hypothetical credit seeker walking into the branch (or completing a loan application online), the first exchange financial institutions are likely to have with customers who are ineligible for the credit product for which they applied is providing them an adverse action or risk-based pricing notice. As of July 2011, the Dodd-Frank Act requires financial institutions to provide several pieces of information to consumers who are either denied access to credit, or who are offered credit, but at terms other than the most favorable for the product. In that scenario, financial institutions now must provide:

- The generic (i.e., FICO or VantageScore) score used to make the decision
- The range of possible scores of the scoring model
- Key factors that negatively impacted the score
- The date on which the score was created
- The credit bureau that generated the score

Banks and credit unions can view the new requirements under Dodd-Frank as a catalyst to spur improvement in the way they serve credit-challenged consumers, and there are many potential approaches to follow. One seemingly obvious approach is to build educational messages around the required pieces of information listed above, or to create educational pamphlets to package with the communication materials that are mandated by regulation. In this paper, we have chosen not to emphasize communications- or education-based initiatives, focusing our discussion instead on various other services and products that consumers can engage with more proactively. We made this choice in part because a great deal of guidance on financial communications already exists in the field.

Moreover, more information – more transparency – does not automatically lead to more informed consumers: in fact, there is a delicate balance to strike between comprehensiveness and simplicity in the provision of complex information. Finally, many of the financial institutions we interviewed for this research said that the potential hazards of straying from the letter of the law with these disclosures are substantial, and hewing strictly to the requirements defined in Dodd Frank provides a needed safe harbor. While the CFPB may eventually consider facilitating future innovation in this area by incentivizing, rather than punishing, financial institutions who want to test improved disclosures, we have formed our recommendations based on the current reality.
What is Credit Building?
By Vikki Frank, Executive Director, Credit Builders Alliance

Credit reports increasingly define who will do business with us and under what terms and conditions. When individuals and their families are “credit-poor” with no credit history or low credit scores, it costs them. It may cost hundreds of dollars per month in higher interest and fees – money that could be used in more productive ways to meet household needs or establish savings for emergencies and retirement. Additional costs may result from the inability to access the relationships required to open bank accounts, rent apartments, purchase needed insurance, and even turn on the lights and telephone service.

Distinct from debt – which is a liability defined by what we owe – credit is creditworthiness and is established through responsible, ongoing financial behavior. Just as a professional resume suffers more from lack of work than from having been laid off, credit reports suffer more from a dearth of activity than from an occasional glitch. Credit scores are an aggregate measure of financial behavior – with active accounts and recent behavior driving the calculation. While it is important to support families to repay debt, it is also essential to support families to not have a “gap” in positive financial relationships that are reported to credit bureaus.

Poor credit in low-income and minority communities is primarily driven by the lack of responsible financial products that can enable people to build a positive credit history. Lenders and consumers alike often focus on trying to decode the unknown “black box” of credit scoring algorithms. And yet, if positive data is lacking, it is impossible for a consumer to achieve a good credit history and score.

Credit building is providing the opportunity for consumers to take on active accounts that they have the capacity to pay monthly and that report to the major consumer credit bureaus. The ultimate credit building product is a no or low-cost credit card product with a sufficient credit limit that serves as a 0% revolving monthly loan holding no ongoing debt. Unfortunately, this option does not exist for many consumers today.

In summary, credit is a financial asset, a credit report is a financial resume, and good credit is a financial outcome. Credit reports, interpreted correctly, offer both a series of teachable moments that can motivate low-income individuals to improve financial behavior and achieve asset goals, and a unique opportunity to measure objective financial indicators (including increased access to affordable products).

About CBA:
Credit Builders Alliance was founded in 2006, with seed funding support provided through CFSI’s Nonprofit Opportunities Fund, to fill a critical gap in the delivery of nonprofit microloans. CBA began by enabling nonprofits to report monthly payments to help underbanked consumers and entrepreneurs build traditional credit histories. In 2008, CBA launched two additional initiatives to serve a broader constituency of nonprofits responding to the credit crisis – access to credit reports for financial coaching and outcome tracking, and a training program that helped nonprofits add credit building as a new tool to their asset building and financial counseling toolbox. Today, more than 250 nonprofits are leveraging CBA’s credit reporting, credit report access and “credit is an asset” training services, sending over 15,000 loans to the credit bureaus monthly and pulling over 50,000 credit reports for counseling and outcome tracking annually.
UNDERSTANDING CREDIT BUILDING WITHIN A FINANCIAL CAPABILITY FRAMEWORK

Becoming “financially capable” is a critical step in the path toward establishing financial security and stability, and the most effective credit building initiatives will aid consumers in becoming more financially capable. CFSI has done extensive research on what it takes to support consumer financial capability, namely that a person is able to: cover monthly expenses with income, track spending, plan ahead and save for the future, select and manage financial products and services, and gain and exercise financial knowledge.

Whereas financial education has traditionally focused on transmitting knowledge to passive consumers, CFSI suggests that financial providers can more proactively promote real improvements in their customers’ capacity to manage their financial lives – in other words, financial capability – by focusing on behavior change more than simple knowledge gains. The basic formula for promoting financial capability can be thought of as access to financial products and services, plus education at the right moment and in the appropriate format. The latter portion of this formula is key, as it elucidates the fact that while education alone cannot make consumers financially capable – education provided in the right way and at the right time is an important part of the process. Financial providers can support customer financial capability in a variety of ways, from simple, communications-driven programs to products and services that are structured for consumer success. The best financial capability-promoting services for consumers tend to be:

- **Relevant**, addressing participants’ specific concerns and financial situations, ideally in a relevant context, to capture their attention and motivate them to change.

- **Timely**, coinciding with key life events or moments of decision that can provide immediate feedback.

- **Actionable**, enabling customers to put newly gained knowledge immediately into action in ways that can improve their financial situation.

- **Ongoing**, developing long-term relationships to provide support, instill a sense of accountability, and track progress.
SHORT-TERM RECOMMENDATIONS: CREDIT BUILDING TOOLS, SERVICES AND PARTNERSHIPS

We begin by describing three services that can help consumers build their credit profiles, whether they have thin credit files, no credit file, or are over indebted: online and mobile-enabled credit score tracking tools, personal financial management tools, and products and services enabled by partnerships with nonprofits. Taking steps to proactively build positive payment history is an important step for all credit-challenged consumers (see sidebar: What is Credit Building?), and the services described below, under “Programs for All Credit Challenged Consumers,” can help in those efforts. For consumers who are over indebted, it may also be necessary to identify interventions that can help to pay down existing debt balances. For these consumers, online debt management programs and credit counseling services may be beneficial (see the next section, “Programs for the Over indebted”).

Because the solutions described in this section could generally be implemented through referrals or partnerships (as opposed to requiring a significant in-house development effort), they can be categorized as short-term solutions, or solutions that financial institutions can implement with relative ease. Many of the proposed solutions are technology-based, making them conducive to scalable implementation at relatively low cost. In general, financial institutions are well positioned to create needed scale in the provision of these services, making them more widely available to the consumers who are most likely to benefit from them.

Programs for Credit Challenged Consumers

Financial institutions that devote resources to improving customer financial capability (See “Defining Financial Capability”) stand to help consumers while also developing a larger customer base.

Some of the most promising programs for providing ongoing support to consumers are those that enable consumers to regularly track their credit reports, helping them to understand how their behaviors connect to their credit profiles in a real-time or near-real-time fashion. Even more effective are tools that pair these tracking tools with advice on how to proactively deal with any problems or issues that arise.

Recommendation: Connect Customers to Online and Mobile-Enabled Credit Score Tracking Tools

The large credit bureaus, as well as Fair Isaac Corporation (FICO), have offered credit monitoring and tracking services, sold for a monthly fee, for some time, but two emerging financial technology companies have recently begun offering this type of service free of charge, and through the increasingly popular (and accessible) mobile channel.

Online credit education platform Credit Karma recently launched a free credit monitoring service. To enroll in Credit Karma’s monitoring program, consumers can sign up online (through a computer or using the browser on a mobile phone) by creating an account and filling out personal details such as name, address, and Social Security number. The consumer then receives credit scores pulled from TransUnion and VantageScore (which are monitored daily), a credit report.
card, email alerts containing any relevant updates, credit analysis, a score simulator, and a credit account management tool. Credit Karma also publishes a blog with educational articles related to credit scoring, reporting and building.

**Credit Sesame** offers a similar free program, available for iPhone users, that provides consumers with regular access to their credit score, as generated by Experian. With Credit Sesame, consumers also receive an email message containing a “badge” (identifying the user in categories such as Good, Excellent and Guru) that he or she qualifies for based on the credit score. Users can then share the credit score badge through LinkedIn, Facebook, Twitter or GooglePlus, enabling them both to show off a good credit track record, and to be socially accountable for maintaining or improving their credit score.

These services can be a valuable tool that enables consumers to engage with their credit scores on a more regular basis, and also creates a check for consumers on their behaviors, setting up a system of accountability. However, there are some limitations. First, the score offered through these services is not the same generic score that lenders access when they evaluate creditworthiness. The Consumer Financial Protection Bureau is currently conducting a study to evaluate the differences between the credit scores that consumers see and those that lenders see. These can be different for a variety of reasons: the score a consumer purchases may be an educational score that is not used by lenders, the lender with which the consumer applies for credit may use a different scoring model than the one reflected in the report obtained by the consumer, or the lender and consumer may rely on reports from different credit reporting agencies.

Additionally, the score or report could change significantly between the time a consumer obtains it and the time the lender seeks the information. However, even if the score that the consumer accesses through a Credit Sesame or Credit Karma is different from the score lenders use in their evaluations, consumers can benefit from having an ongoing measure of how their credit score is changing in response to their behaviors.

Both Credit Karma and Credit Sesame are available to consumers without the intervention of financial providers. However, banks and credit unions could proactively refer consumers to these services. Whereas Credit Sesame and Credit Karma do not themselves offer financial products, banks or credit unions offering this type of service to the consumer have the ability to use a similar service as a relationship building tool.

**Recommendation: Connect Customers to PFM Tools, Or Build Your Own**

Credit monitoring services are targeted in the service they offer to consumers, but several other online financial management tools exist that enable consumers to see a broader picture of their finances on an ongoing basis. For low- and moderate-income consumers, online personal financial management (PFM) tools can take on the role that financial advisors often play for more affluent consumers. As noted in CFSI’s 2010 paper, *From Financial Education to Financial Capability: Opportunities for Innovation*, further evaluation and testing is needed to determine the real impact of these programs for consumers. But the ability to offer financial advice in a scalable and low-cost way through the Internet holds a great deal of promise. One PFM tool that is notable for its unique attributes is **HelloWallet**.
HelloWallet is a PFM tool that consumers access through their employer’s human resources department. HelloWallet earns revenue by selling the service to HR departments (at a low cost per user) rather than through advertisements or referrals. This is beneficial because advertisements can create confusion for consumers, and also may appear to be endorsed by the PFM provider when they are not; referrals can create the appearance (and in some cases, the reality) of a conflict of interest, because the PFM provider may be tempted to refer consumers to providers who return the highest fee to the PFM provider, rather than to the financial service most suitable for the consumer. Because HelloWallet is offered through the workplace, consumers receive the service free of charge, and potentially with technical support and guidance through the employer’s HR department. Further, while HelloWallet is not specifically designed to inform consumers about their credit standing, it can help its users to see how their credit use connects with their broader financial lives, making it a useful credit-building tool nonetheless.

Financial institutions may look to HelloWallet as an example of how to use technology to provide credit-building and general financial management support to underserved consumers. While banks and credit unions clearly have an interest in recommending their own products to customers, it is reasonable for them to do so, so long as the advice is sound and the product referrals are relevant and advantageous to the customer. In this case, while there may be tension between the provider’s and the customer’s priorities, it can be managed in a way that creates mutual benefit for both. Banks that already offer online money management tools should continue to invest in the tools to ensure that they remain user-friendly and intuitive. This may be done through formal or informal consumer research initiatives, which evaluate consumer usage and preferences related to these tools, or through analytics that examine which customers are using the tools and in what manner.

Recommendation: Partner with Non-Profits to Offer High-Touch Products and Services

Thanks to their grassroots approach, nonprofit providers tend to be particularly in tune with customer needs and well equipped to identify and respond to these needs. Nonprofits can play a number of roles for consumers, from coaching and counseling to referrals to financial institutions to offering basic products on their own. A small number of nonprofits have successfully partnered with larger financial institutions to make their programs more scalable. These partnerships have the potential to benefit everyone involved. The financial institution partners get access to a solid pipeline of future customers. The nonprofit partners get needed support – financial and otherwise – for their programs. Consumers get guidance that may be more hands on than what the financial institution would provide on its own.

Nonprofit partnerships may be less scalable than the technology-enabled solutions proposed above, in large part because there are relatively few examples of nonprofits that could partner effectively with banks on a national level. However, a great deal of potential exists for regional and local nonprofits to partner with regional and local banks and credit unions to effectively promote credit building among low- to moderate-income consumers. These partnerships are worth pursuing because of the significant benefits they can yield to the financial institution, the customer, and the non-profit.
Justine Petersen is a St. Louis-based nonprofit that has partnered with Citi Banamex to offer financial education to community members. The education provided by Justine Petersen is likely to be more effective than most because it is combined with a product that aligns with the immediate customer need: a secured credit card, which enables customers to strengthen their credit scores with minimal risk to them or to the provider. Consistent with the principles of financial capability, Justine Petersen offers education in a timely fashion, paired with a product that is highly relevant to the consumer. The education component includes a requirement that clients take one financial education webinar in order to open the card. Clients also can be reimbursed by Justine Petersen for the $35 annual fee if they make on-time payments for 12 months and take two one-hour financial education webinars.

The pairing of education with the secured card helps consumers use the product in the most effective way: for example, customers are encouraged to extend only a small portion of the credit line available to them in order to ensure that they can demonstrate good behavior and build their credit profiles in the most efficient manner possible. In fact, consumers at Justine Petersen have seen a 50-point credit score improvement, on average, over seven months of using the secured card. Financial institutions that seek similar partnerships with nonprofits may find that they can efficiently funnel needed services to consumers without a resource-intensive staffing or programmatic effort. Alternatively, banks and credit unions can simply offer referrals to local community organizations that provide these services independently.

Programs Specifically for the Over Indebted

Following the glut of credit extended to consumers leading up to the financial crisis, as many as 144 million consumers are overburdened by debts that may be impossible for them to repay. For these consumers, in addition to working to build positive payment history, they may also need to take steps to address accumulated debts in order to build their credit profiles.

Recommendation: Connect Customers to Online and Offline Debt Management Programs

A number of effective programs and products are available today that can help consumers consolidate and pay down their debts, but consumers may struggle to find them or to identify the solutions that are best for them. Receiving connections from a trusted financial provider may give consumers more comfort with a given solution. Having received this help from a financial institution, customers are more likely to return to that provider for future needs, creating a strong basis for an ongoing and eventually profitable relationship.

To broaden consumer access to these types of services, financial institutions should consider either referring consumers who need debt management assistance to programs like SavvyMoney or ReadyforZero, developing partnerships with similar providers, or creating in-house solutions that consumers could enroll in.

Because these programs are all designed to respond to an urgent consumer need, offer consumers tangible steps to reduce their debt burden, and work with the consumer over a period of time to reduce their indebtedness, they fit the criteria of effective financial capability services: relevant, timely,
actionable and ongoing. However, because these programs are targeted to people who may be in desperate need of help in managing their debts, the risk of consumers being taken advantage of is high. In order to be considered high quality, debt management programs should be transparent in their offering, the risks and impacts of the program on the consumer’s credit score should be clearly described, and the costs of participating in the program should be reasonable.

Financial technology companies have entered the debt reduction space, and these providers offer the promise of inexpensive and easily accessible debt management help for consumers. **SavvyMoney** and **ReadyforZero** are two providers that offer low-cost programs to help consumers pay down their debt in a manageable and systematic way. SavvyMoney claims to help the average member pay down $6,200 a year of debt (unaided by an increase of income)\(^{13}\). The online tool enables consumers to see all of their debts – and the terms of their debts – in one place. Members can then choose a payment goal and one of three structured payment plans to follow. The tool recommends how much the customer should pay down for each account, and it shows the member’s progress over time on paying down principal and interest. SavvyMoney goes further to suggest additional steps the consumer can take to clean up his or her financial life to make it possible to pay down the debt even more quickly. Additional features available through SavvyMoney include an educational blog and several calculators to help the user evaluate rate negotiation, interest savings through paying down debts, optimizing credit cards, and debt-to-income ratios. ReadyforZero offers a similar service that helps consumers develop a plan for managing and paying down debts, and the service includes the option for the consumer to set up automatic reports to send to family and friends, creating social pressure to stay on the plan.

In the physical world, consumers who have become delinquent on debts generally have four options for working through it: pay it off in full, undergo debt settlement, obtain credit counseling (described in more detail below), and declare personal bankruptcy. The latter three can negatively impact the consumer’s credit score before helping it, but they can ultimately benefit the consumer by helping him or her to eventually achieve a clean slate. The best path is often determined by a host of factors, including the consumer’s financial situation, the extent of debts outstanding, age, and more. It’s important to note that these options are not without consequences for consumers – not only in terms of the consumer’s credit score, but also in terms of societal perceptions – and that consumers who choose to go down this path must carefully navigate around the unscrupulous players who seek to take advantage of people when they are most vulnerable.

Credit counseling or debt management programs were created by banks in the 1960s. These organizations are generally non-profits that receive referrals from banks to customers who need help managing their debts. Credit counselors charge customers a small fee (which is often waived) for using the service. With credit counseling, all creditors are repaid at the same rate. The agency comes up with a single monthly payment that consumers pay to the agency. The agency then uses those funds to pay each of the creditors. **Clarifi**, a consumer credit counseling service based in the Delaware Valley, has evaluated the demographics of its customers and found that about half are considered low- to moderate-
income consumers. The average income for customers is around $60,000, and the average debt load is near $30,000.

**What is High-Quality Credit?**

CFSI has traditionally defined “high-quality credit” in the following terms: It must be marketed transparently and priced fairly. It must be affordable and structured to support repayment—without creating a cycle of repeat borrowing or “rolling over” of the loan—and should support credit-building. Ideally, it may also be accompanied by other features, such as a savings account or budgeting advice that can prepare the borrower for greater financial prosperity over time. However, the additional complexity created by such features must be balanced against the convenience, speed, and privacy consumers demand and the additional costs they create for the lender. CFSI continues to evaluate the characteristics of high-quality credit through the Compass Principles initiative.

**MEDIUM-TERM RECOMMENDATIONS: RISK-LIMITED, CREDIT BUILDING PRODUCTS**

Financial institutions that seek to go beyond educational initiatives and referrals may consider offering customers who seek a credit product – for which they are not initially qualified – risk-limited, credit-building products that reduce the risk both to the customer and to the financial institution. Different financial institutions offer various versions of products intended to help consumers build their credit scores. Offerings include credit-builder loans, secured credit cards, low credit lines, and loans that are structured so that their terms improve with good repayment behavior. In order to be positive for consumers, these products must also meet the criteria of being high quality (see “What is High Quality Credit?”).

The products described in this section may be thought of as medium-term solutions for financial institutions to consider offering to their customers. Unlike the referral- and partnership-based solutions outlined in the previous section, the solutions highlighted here may involve a more intensive product-development and marketing effort. While developing and offering these products may require more effort and expense, they also hold the potential for greater reward for financial institutions: by offering products that enable customers to proactively build their credit profiles, and by closely monitoring customers’ use of these products, financial providers may be able to expand their relationships with these customers more deeply, yielding increased profit opportunity through additional product offerings.

**Recommendation: Develop and Market Secured Credit Products or Credit Builder Loans**

Secured credit cards, loans and lines of credit are a common product offering among major financial institutions, though these products generally represent a very small proportion of the lending portfolio. These loans or lines of credit are generally backed by collateral that is equal to the amount of credit extended (or, in the case of partially secured credit, the amount of collateral will be less than the amount of the loan or line), and these products generally report repayment behavior to credit bureaus.
CFSI identified several best practices for secured credit products, which include: creating credit builder loans that provide a disciplined path toward savings, offering budgeting and expense tracking features along with the product, creating a structure that enables customers to graduate to a partially secured or unsecured structure over time, and partnering with a nonprofit to offer products coupled with financial education to help consumers focus on building their credit profiles to position them for borrowing under improved terms in the future.

Several secured products exist in the market today, although they are generally a somewhat neglected product in a bank’s total loan portfolio. In most cases, these products could be marketed more effectively and bolstered with features that help consumers better manage the account.

For customers who lack sufficient collateral upfront, credit builder loan products, many of which use the loan proceeds to collateralize the loan, may be the best option. Customers taking out credit builder loans generally do not leave the financial institution with money in their pockets, but instead, the “loan” is structured as a forced savings vehicle. Self-Help Credit Union currently offers a Credit Builder loan. A customer using this product chooses a dollar amount from $500-3,000, and then is required to make a monthly payment into what is essentially a locked savings account until they reach the target amount. The term of the loan varies, depending on the loan amount, but the maximum term is 24 months. The cost of the loan to customers is 4% over the prevailing annual interest rate for savings accounts. In addition to enabling the customer to save money through a consistent monthly contribution, the Credit Builder loan reports repayment behavior to credit bureaus, so customers who consistently pay on time can benefit from an improved credit score. Many credit unions offer a similar product with varying loan amounts and interest rates that vary up to 18% APR for the cost of the loan.

Since customers using the Credit Builder loan are paying to contribute to a savings account, it does not make sense for someone to use a product like this purely as a savings vehicle if they have the ability to save on their own. However, in addition to helping consumers build their credit scores, the product can create a disciplined structure for setting aside money regularly, which many customers need in order to make consistent contributions to savings. Further, once the original loan is fully paid off, customers are not only left with a savings balance to use as they choose, they also have the ability to graduate to other secured credit offerings. From Self Help’s perspective, this product requires little underwriting, since it is fully secured and no lending capital leaves the credit union when the loan is issued.

For customers who do have some cash that they can set aside as collateral, a secured card, line or loan may be an appropriate borrowing option. Most major financial institutions offer some kind of secured credit card to consumers. Wells Fargo offers a secured card with a credit line of $300-10,000, which can be secured with an equal amount of collateral. Wells’ product includes a few special features that can help customers manage their budgets more effectively. Two such features, My Spending Report and Budget Watch, help customers with budgeting and expense tracking. Customers can also set up transaction alerts for their mobile phones.
Customers who demonstrate responsible repayment behavior may be eligible to graduate to a partially secured or unsecured product over time.

**Justine Petersen**, mentioned above, provides a good example of a partnership between a nonprofit and a bank to offer secured credit cards to consumers. In the case of Justine Petersen, the secured card, offered through Banamex, a subsidiary of Citi, comes with education and guidance on exactly how to use the card so as to make best use of the product to build credit. While most financial institutions are unlikely to commit the resources necessary to provide this type of specific coaching, nonprofits are well positioned to help customers use the product as effectively as possible, in order to gain access to better options more quickly and efficiently. For example, customers are given a minimum credit line of $300, but they are encouraged to use only a small portion of the line so as to demonstrate responsible behavior to credit bureaus. Because one of the benefits of these products is that they support reporting of repayment behavior to credit bureaus, an obvious potential pitfall for consumers is that they harm their credit standing if they do not make payments according to the cardholder agreement. Thus, the additional coaching that can be provided through nonprofits may be especially useful for the most vulnerable borrowers. The valuable services that nonprofits offer to consumers can be made more scalable and thus more widely available to consumers through partnerships with financial institutions.

The primary challenge for secured card and credit builder products is, in fact, that financial institutions often do not proactively promote these products.

In some cases, a secured card, loan or line of credit is offered as a turn-down or counter-offer product for customers who request – and don’t qualify for – a different credit product. However, sales staff may be hesitant to offer the product even under these circumstances, fearing that they could offend the customer by offering him or her a product that is perceived as inferior to an unsecured credit product. As mentioned above, successful positioning of these products will likely require analytics as well as an educated sales staff who can identify eligible customers and offer products to them in both proactive and reactive situations. The need to invest resources in staff training may pose an additional barrier in the deployment of these products. However, financial institutions may benefit from thinking of secured products as pipeline builders, helping to train customers to responsibly take on additional credit in the future.

**Recommendation: Develop and Market Low Credit Lines**

Another way of offering small-dollar credit to consumers who lack a sterling credit record is to offer them a small amount of unsecured credit through a small-dollar installment or other loan or low credit line. As unsecured products, the barrier of needing collateral to obtain the product is removed, and like secured products, they typically report repayment behavior to credit bureaus. There are two primary risks to financial institutions in offering these products. The first is the risk that the provider offers too much credit too quickly, setting the consumer up to take on too much debt without proper underwriting, creating harm for both the consumer and the bank. The second risk is that the customer may get poached by another provider once he or she has developed a good track record of repayment, preventing the original financial...
Medium-term Recommendations: Risk-limited, Credit Building Products

Financial institutions can mitigate these risks in a couple of ways. One is to maintain a high level of engagement with the customer, tracking behaviors and, if appropriate, offering them new products with better terms when the customer is ready. Another way to mitigate the risk of losing a customer once he or she has developed a good track record is to bundle the line of credit with other products (these risk mitigation strategies apply to secured card offerings as well). For example, Keybank’s Key Basic Credit Line can be linked to a checking account to provide overdraft protection. Finally, the development of credit reporting incentives through regulatory and policy change may also help to mitigate this risk over time.

Recommendation: Offer Loan Terms that Improve with Good Behavior

A final way of extending credit to thin/no file consumers and consumers in lower credit tiers is to offer loans with terms that improve with good behavior. Wells Fargo and Capital One are two secured card providers that offer products which enable customers to graduate to a partially secured or unsecured product. Billfloat, a short-term, small-dollar lender that helps its customers pay recurring bills such as utility bills or cell phone bills, is structured so that customers who consistently repay loans on time can use the service to pay more bills and get a higher credit line for future needs. Similarly, Citi’s Forward card offers cardholders APR reductions when they stay under their credit limit and pay on time for three billing periods in a row.16

Among nonprofits, credit unions and financial technology companies, other examples exist of loans with terms that improve in response to good repayment behavior. In the credit union space, a product created by the Filene Research Institute is a good example of how to reward consistent, on-time loan repayments. The LIFT (Low Interest for Timeliness) project, funded in part by CFSI’s Financial Capability Innovation Fund, gives borrowers the ability to earn a reduced APR for on-time payments: for every three consecutive on-time payments borrowers make, they receive a 0.25% interest rate reduction on the loan. The savings earned through lower interest go toward repaying loan principal, reducing the life of the loan. LIFT is being tested in a national pilot with 6 credit unions, representing nearly $2.5 billion in assets, and targeting 1,200 borrowers to evaluate the potential for this structure to boost borrower credit scores and improve financial capability.17

Recommendation: Invest in Marketing Efforts for Credit Building Products

For the types of products described above, marketing is key: in many cases, products are targeted to a relatively small portion of the total customer base, so targeted marketing is needed to be sure that the customers who are eligible for the products know about them, and know how to access them. Customer research and segmentation, to identify customers for the product, may help. A degree of customer education may be necessary with these products as well, because consumers may not understand the products or their benefits. While taking out a collateralized loan or line of credit may seem less appealing, at first blush, than an otherwise similar unsecured product, if consumers understand the benefits of these products and how secured credit can put them on a path to broader product offerings, they may be more interested. A knowledgeable sales force is key to successfully offering and
marketing these offerings. CFSI’s research on these products revealed that most financial institutions are not taking necessary steps to ensure that their frontline staff are well equipped to promote the product, under the right circumstances and to whom. Short-term incentives offer one means of motivating the sales force, which may be effective for some organizations. Others may choose to emphasize staff education on the products and their use cases.

**General Purpose Reloadable Prepaid Cards as Credit-Building Tools?**

There have been some recent indications that general purpose reloadable prepaid products may soon report transaction data to credit bureaus, providing an additional layer of payment information on a population of customers that overlaps significantly with thin and no file consumers. Experts in the underbanked financial services field have long speculated about the possibility of using prepaid transaction data to evaluate creditworthiness. With Suze Orman’s recently announced general purpose reloadable prepaid card, the **Approved Prepaid Mastercard**, the company has indicated plans to share anonymous transaction data with credit bureau TransUnion to determine if it could be used to assess creditworthiness. The card also comes with free unlimited access for consumers to their credit score, provided by TransUnion. This is a unique feature for a prepaid program, and it may presage more to come from other prepaid providers. Other prepaid providers have explored this type of service in the past, but the fact that a high-profile financial services pundit is taking this step with a new product is notable.

If prepaid transaction data is determined to be predictive, and if prepaid programs began to incorporate credit reporting to the major bureaus into their product features, it would benefit consumers and providers alike. Consumers would have a new avenue for demonstrating positive repayment behavior, and providers would likely benefit from greater retention and deeper usage of their prepaid cards for day-to-day purchases. An additional example of a prepaid program that enables consumers to benefit from a history of good behavior is **American Express’s Make Your Move program**. This program is set up so that users of the company’s prepaid card may be invited to apply for a charge card after developing a good track record. The sharing of customer data does raise potential privacy concerns, and providers should carefully weigh the risks and benefits to consumers of sharing sensitive data. Further, financial companies must provide clear disclosure to consumers on what information is being used – and how it’s being used – as well as a straightforward means of opting out.

Meaningful expansion of the types of data that can be used to evaluate creditworthiness depends on the data being FCRA compliant, in order to protect consumers from unfair use of data, and to protect financial institutions from violating their regulatory requirements. In addition, a great deal of work will be needed from the credit bureaus to expand the existing reporting infrastructure to include new forms of data.
LONGER-TERM RECOMMENDATIONS: GO BEYOND TRADITIONAL CREDIT FILES

For those customers who enter the branch looking for a credit product – and do not qualify for credit on the basis of a primary screen because of a thin credit file or no file – an additional option for identifying the right lending approach is to look beyond traditional credit reports to see if other data can be used to evaluate the creditworthiness of the customer. This final section describes an area that is likely to require the most significant effort on the part of financial institutions, and may demand systemic change in order to spur a widespread shift in and industry-wide understanding of the types of data that are compliant and readily accepted in credit decisions.

Recommendation: Consider New and Deeper Sources of Data for Credit Decisioning

While thin- and no-file consumers lack a complete record of borrowing history within the traditional credit reporting system, many of these consumers have, in fact, demonstrated responsible repayment behavior with a deposit account, or through the payment of utility, cell phone, rent, and other bills. According to an analysis of thin-file consumers conducted by VantageScore, from 2007-2009, the average VantageScore of thin file consumers was 676, and 46% of thin file consumers had a score higher than 700 (scores of 701-900 are considered prime, and 900+ are super prime). VantageScore defines thin file consumers as those who have two or fewer tradelines in their file, and these consumers are evaluated separately from full-file consumers.

For multiline providers with an existing account relationship with a thin or no file customer who is seeking access to a credit product, it may be possible to create a more nuanced and detailed picture of that customer using information that’s already held within the bank’s data storehouse. Data points that could be used include tenure with the bank, current and past relationships with the bank, deposit account balances and behaviors, overdraft history, and savings balances and behaviors.

CFSI’s research shows that many financial institutions are doing this in small ways, but most could do more to plumb and analyze customer data. Developing this type of internal score may be particularly applicable and beneficial for small-dollar credit offerings, since the lower dollar amounts of these loans pose less risk relative to larger loans (e.g. mortgage loans), and because consumers seeking these types of loans are more likely to have a thin file or no credit file.

In order to lend to more consumers without taking on additional risk, financial institutions may also consider exploring the potential of using alternative credit data to create a fuller picture of a potential borrower’s repayment history. Financial institutions should consider using third-party data provided by alternative credit bureaus to supplement the data they have access to in-house.

Alternative credit data companies report on such data as rental payments, utility payments, cell phone bill payments, payday loan payments, and public record information (bankruptcy filings, liens, property deeds, professional licensures, address records). These companies have different ways of collecting, analyzing and sharing the data,
Longer-term Recommendations: Go Beyond Traditional Credit Files

and financial institutions increasingly have a choice of several third-party alternative credit data companies with whom they could partner. Companies such as L2C, Lexis Nexis, and ID Analytics are prominent players in the alternative credit data arena, and the Big Three bureaus are also beginning to incorporate more and more varied data into their scoring models. For example, in June 2010, Experian acquired a company called RentBureau, which uses rental payments to evaluate consumer creditworthiness. RentBureau scores are now incorporated into Experian’s scoring model, which is a significant achievement and validates the importance of alternative credit data. More research is needed to evaluate the impact of these types of data on consumers and access to credit products over the longer term, but these systems offer a great deal of promise.

One complaint that is lodged in relation to alternative credit data is that the use of this data can harm consumers more than helping them. However, negative information about failure to pay for services such as utilities and rent generally makes its way into credit scores through reporting by collections agencies – while positive information about consumers paying these bills consistently is far less likely to enter the traditional reporting system. Further, financial institutions generally are using alternative credit data on consumers they would otherwise reject, not as a tool for screening all customers, so any incremental information on the customer’s repayment behaviors is most likely to improve the customer’s chances of gaining access to credit.
Conclusion

When a customer applies for a credit product that he or she does not initially qualify for, banks and credit unions have many options for next steps with the customer to strengthen their relationship and support the customer’s desire to access high-quality credit. Between making referrals to third-party companies and organizations that help consumers monitor and manage their debts, designing and promoting credit-building products that mitigate risk for both the customer and the provider, and using enhanced analytics to improve the decisioning process, banks and credit unions should never have to turn a customer away empty handed. Not only does this benefit the consumer, but financial institutions that implement the strategies recommended in this paper can benefit from portfolio growth, greater engagement with their customers and an opportunity to develop a strong pipeline for future lending.

The recommendations in this paper are relevant beyond the hypothetical customer who applies for and is denied credit through a financial institution. Banks and credit unions should consider offering the types of services described throughout the paper to a wide range of consumers, as even those who are not credit challenged in some way stand to benefit from being more in tune with their credit profiles. Beyond traditional financial institutions, other innovators, from financial technology companies to credit bureaus, should continue to invest in solutions that can help consumers improve their credit profiles. Providers of all kinds will benefit from more informed and more credit-worthy customers.
Companies and Organizations Mentioned in this Paper:

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