A F F O R D A B L E H O U S I N G

ISSUES

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Individual Development Accounts

A description of Individual Development Accounts (IDAs) is presented in the February 2005 issue of Insights published by the Controller of the Currency (see: www.occ.treas.gov/ftp/release/2005-25a.pdf). An IDA is described as a tool for lower-income households to save money and build assets for goals such as the purchase of a home or starting a small business. In addition to describing IDAs, the paper discusses why the IDAs are of interest to banks, how an IDA works, the risks associated with IDAs, who is in the IDA business today, and how the cost structure works. Since the number of IDA programs in the US has grown from only three in 1995 to over 500 in 2002 with over 20,000 account holders, organizations in Florida may wish to investigate Individual Development Accounts for their communities.

What Are IDAs?

An IDA is reminiscent of matching arrangements in 401(k) plans. That is, the IDA is a matched-savings account established for a specific purpose (e.g., buying a home, forming a small business, furthering an education) usually for a term of one to four years. Federal, state, and local governments or non-profit organizations provide matching account contributions typically ranging from one to three dollars for every dollar contributed by the account holder. This arrangement offers more encouragement to low-income families for asset accumulation than the typical tax incentives of IRA or 401(k) deferrals because the lower-income families lack the financial resources necessary to take advantage of them. In addition, by combining economic incentives and education, more people will be encouraged to save for a particular financial goal.

Why Are IDAs of Interest to Banks?

Banks and other financial institutions clearly are key players in IDA programs. Their decision to participate, however, typically stems from recognition of the sound business opportunities presented.

Market expansion and customer development comprise one such opportunity. As IDA participants achieve their financial goals, they will need additional savings and credit services. Those same customers, who may be experiencing their first relationship with a bank as an account holder, will also bring new customers to the bank. There is also the potential for participation in IDAs to be a CRA consideration under the three tests for CRA credit: lending, investment, and service. Since non-profits often act as sources of matching funds for the account holders, they are service providers for the IDA initiative and can bring additional banking and customer relationships to the bank. Finally, the banks that are aggressive IDA participants may view participation as a positive community economic development initiative.

How Do IDAs Work?

IDA programs typically involve three main parties and each has a clearly defined role.

Program Participants - The program participants are by definition low- or moderate-income people who enter the program because of the marketing or recruiting efforts by the nonprofit provider administering the program. Once in the program, the participant commits to save a specified amount of money over a defined period. All programs have limitations on the number of missed deposits during the contract period. In addition, no funds may be withdrawn from the IDA prior to reaching the agreed upon goal amount, except for emergency needs. In addition to meeting savings goals, the participants are generally required to attend financial literacy training. Participants may also be required to attend training geared to their particular asset goal, such as homebuyer education or micro-enterprise entrepreneurial training.

Nonprofit Service Providers - The non-profit service provider drives the IDA product and process. These partners, who also take on the responsibility for marketing and outreach to potential IDA clients, generally perform program administration. They are involved in fundraising for both operating and match dollars. They also conduct the screening of IDA applicants by reviewing their financial histories and the banks generally rely on the recommendations of the non-profit. The service provider also provides education, training, and technical assistance to program participants.

Financial Institutions - The banks hold the savings accounts for the program participants and generally either waive or substantially reduce initial deposit requirements and account fees. The IDA program participants are paid market interest rates. Banks generally send regular account statements to the participant and a duplicate statement to the nonprofit service provider. Banks also may provide program support through employee participation on boards and advisory committees for the non-profit service providers, and by assisting the non-profit in providing financial literacy training and technical assistance to program participants. A number of banks also assist the non-profit partner with the operational work involved in allocating match funds to individual accounts.

Partnership Model - Non-profits are usually the initiators of the dialog with a bank about starting an IDA program. The non-profit usually is interested in providing IDAs to its clients or in its service area. Approximately 70 percent of IDA partnerships are the result of an on-going relationship between a non-profit and a financial institution. The majority of IDA partnerships are structured in accordance with a formal agreement. These agreements outline the specific responsibilities of each party. The bank usually handles the financial transactions while the non-profit handles the marketing and management. The agreement describes how accounts are opened, account features and fees, how deposits are made, and when withdrawals are permitted.

If the bank is providing match funds, the agreement will specify the match rate and the maximum contribution per account.

How Much Do People Save with IDAs?

It was found that the average monthly net deposit of a participant was $25.42 and that on average participants made a deposit in seven of 12 months. With an average match rate of 2:1, participants accumulated assets at rate of $75 per month or $900 per year.

Communication among the bank, the non-profit, and the participant regarding the progress being made by the participant has been found to be a critical element of successful IDA programs. Until an IDA customer completes the program and achieves their financial goal, a participating bank's primary customer is the non-profit service provider. Although the accounts are established in the individual participants' names, the accounts typically require dual signatures of both the individual participant and the non-profit for any type of withdrawal. Generally, a separate master trust account is established to hold the match funds with sub-accounts identifying the individual participants' share. The master accounts often hold hundreds of thousands of dollars in match funds on deposit, as they are received from the funding source. A bank may hold either the individual bank accounts, the master account for the match dollars, or both.

Key Risks and Regulatory Issues

Because IDAs are deposit accounts, there is minimal associated credit risk as long as proper transaction controls are in place. However, as a deposit account, banks must comply with all of the traditional disclosures called for under the Truth in Savings Act (implemented under the Federal Reserve's Regulation DD), as well as any other relevant regulations associated with the type of savings accounts established for a specific IDA program.

Banks will face reputation risk and possible penalties if they fail to perform their duties properly as custodian for IDA funds. Such failures would include permitting early or unauthorized withdrawals from the IDA account. IDAs are established to encourage participants to save their funds for an important asset goal, rather than using the funds for discretionary purposes. Therefore, banks and their non-profit partners usually establish some level of controlled access to the funds in the accounts to prevent withdrawals not associated with the asset accumulation goal. As a result of this risk, banks with large numbers of branches typically select targeted branches to administer an IDA program for control purposes.

In considering whether to implement a new IDA program, banks evaluate whether IDAs will fit into their overall business plans. As with any product or service offered by a financial institution, careful due diligence must be executed prior to implementation. For example, banks should ensure that the non-profit partner is reputable and has sufficient resources to execute its responsibilities related to the IDA program in a proper fashion. Banks should clearly understand what their own role will be in the program and have a realistic estimate of the extent to which bank resources will be devoted to the program.

Regarding customer identification concerns, the Customer Identification Program (CIP) rule implementing Section 326 of the USA Patriot Act outlines procedures for banks to follow in order to verify the identity of a customer that opens an account. It is essential the participating banks continue to perform these background checks as directed by the Act.

Who Is in the IDA Business Today?

Banks comprise 81 percent of the financial institutions sponsoring IDAs and credit unions account for the remainder. Most of the programs are small (e.g., have less than 100 accounts) and are structured in partnerships with non-profit providers and financial institutions.

Programs generally include a financial literacy component that is considered to be key to achieving any measure of financial success.

Larger banks are more likely than smaller banks to offer IDA programs. While banks with assets of less than $1 billion sponsor nearly half of all programs with 50 accounts or less, banks with assets greater than $1 billion sponsor 79 percent of programs with 51 to 100 accounts, and 84 percent of programs with more than 100 accounts.

Many of the Federal Home Loan Banks (FHLBs) sponsor structured savings programs for mortgage down payments that are similar to IDAs. Once participants have saved their target amounts, their deposits are matched at mortgage closing. Other programs that assist people with asset growth, and are conceptually similar to IDAs, include the Family Self-Sufficiency Program that incorporates HUD Section 8 Homeownership funding.

Summary

Individual Development Accounts (IDAs) are a tool that can provide banks with a means of tapping new markets of customers that traditionally they have had difficulty reaching and at the same time supporting community development. Although IDA holders initially will have only a small savings account relationship with the bank, the expectation is that they could become profitable customers in the future as they develop greater comfort with financial products. While IDAs are currently individual programs offered primarily through locally based partnerships between financial institutions and nonprofits, IDAs have the potential to achieve greater appeal if they became a more standardized product with greater financial incentives for banks to participate, less operational burden for all parties involved, and larger and more stable sources of match funding.

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