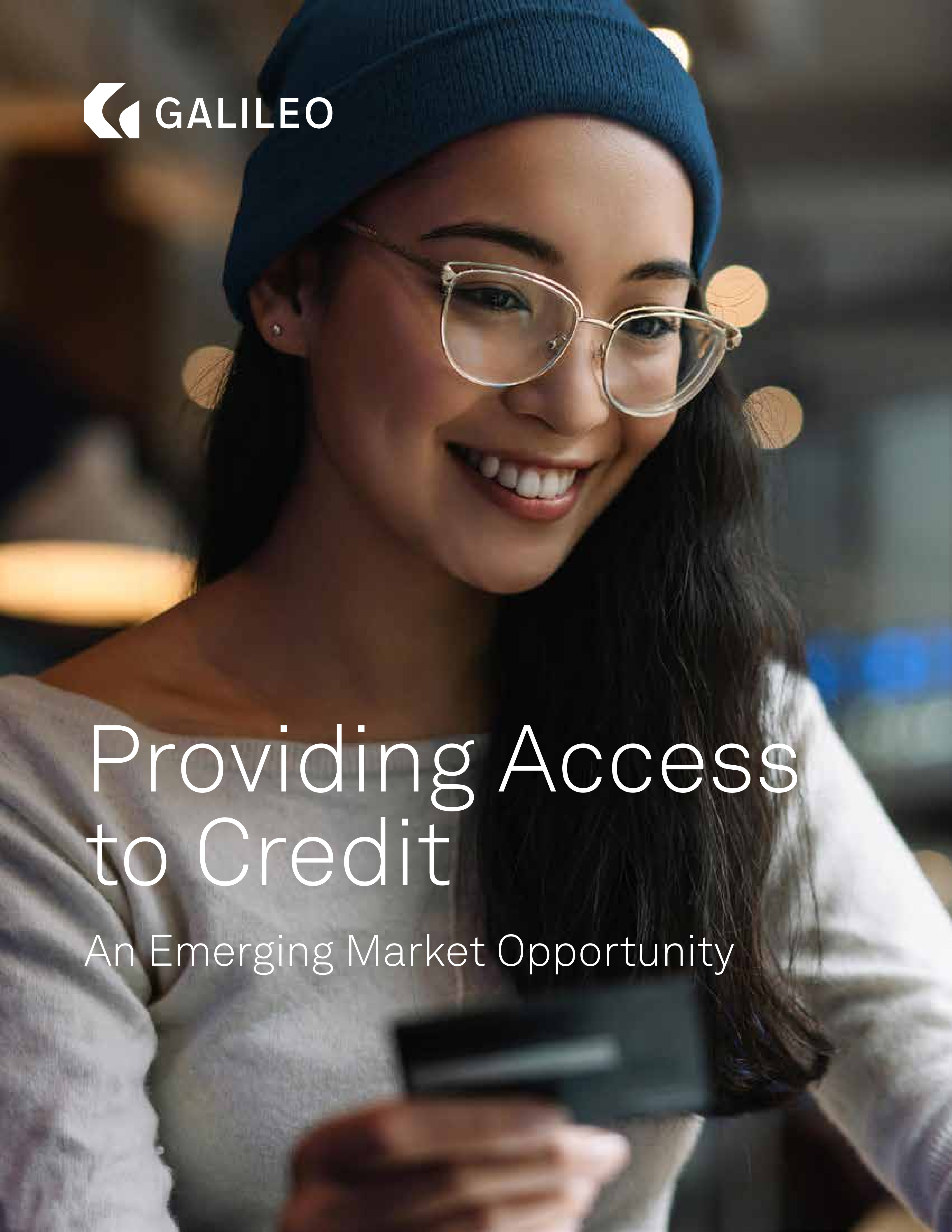
GALILEO

# Providing Access to Credit

## An Emerging Market Opportunity



# Secured Credit Drives Fintech Growth

The COVID-19 pandemic has served to highlight economic inequalities in the United States and the deep disparities between the haves and the have-nots. Ironically, while the federal government promises to address the issue by taking on racial disparities and helping create a more even playing field, the private sector, specifically the fintech industry, has been hard at work doing just that.

Despite their many benefits, secured credit cards are underutilized by the population that would most benefit from the opportunity to build credit.

Secured credit cards make up only a small fraction of the credit card market at nearly 6 million active lines. At the same time, there are an estimated 108 million consumers whose credit score, or lack thereof, prevents them from accessing affordable, high-quality credit when they need it. The potential market for secured credit cards is huge.

Over the last decade and half, a host of start-up neobank and challenger banks has expanded financial inclusion by focusing on underserved segments of the consumer financial market with innovative, technology-based products, such as mobile banking apps, debit and prepaid cards, and other digital financial solutions. But in spite of their success making financial solutions available to a wider group of users, the fintech industry, **valued at over $5.5 trillion**, along with traditional financial services providers have had limited or minimal success addressing one of the fundamental issues of economic in equality: access to credit, which enables individuals to pursue economic opportunities and enjoy financial security.

Today, although estimates vary, there may be as many as 121 million[1] people, typically categorized as "unbanked" and "underbanked," who have thin credit or poor credit and, thus, limited or no access to traditional credit resources. Interestingly, this segment is typically thought of as consuming of the young, i.e., college students and Gen X and Yers, immigrants (many of whom have no credit history and/or are undocumented) and the poor.

## Addressable Market

Based on the estimate of 121 million people with thin or poor credit, the addressable market for secured credit cards could be in the vicinity of $1 trillion annually. [2]

In today's digital global economy there is also a growing class of upscale digital nomads, who choose to work remotely, often from countries other than their own, and find themselves with credit access issues. Similarly, there are international professionals—think H-1B visa holders—who find their access to credit in the form of a mortgage, car or boat loan restricted in the country they have relocated to for work.

Qualifying for credit requires good credit. This catch-22 impacts the estimated 121 million people* in the U.S. who have poor or thin credit.

# Legacy Solutions

Brick-and-mortar banks have sought to address this lack of credit access with the introduction of secured credit cards, which are backed by a cash security deposit and designed to help individuals build a credit file. Although most banks with significant credit card portfolios (along with some smaller institutions, including those that target underserved markets) offer both secured and unsecured credit cards, the number of secured credit cards in circulation—while difficult to estimate—remains low, perhaps as few as 6 million.[3]

This compares to nearly 700 million unsecured American Express, Discover, Mastercard and Visa credit cards in the United States in 2021.[4]

> "Becoming a part of the banking and financial system in the U.S. is a pathway into being a shareholder in the U.S. and having a vested interest not just in yourself, but also in the well-being in your community and the country as a whole."[5]
>
> – FDIC CHAIRMAN JELENA MCWILLIAMS

## Why is the market penetration of secured credit cards so low when the need for credit-building products is so great?

Part of the answer lies in the lack of incentive for brick-and-mortar banks, with their high cost basis, to develop large secured credit card portfolios, which may be marginally profitable or even unprofitable based on the limited interchange revenue that can be generated on low credit lines.

This means banks either must support a large enough credit card portfolio to absorb the losses/marginal profitability of secured credit cards or accept the reputational risk of assessing fees and comparatively high interest rates that push secured credit cards into profitability. And, this isn't, necessarily, about banks being greedy. Regulators don't look favorably on banks supporting unprofitable products, nor do they have tolerance for bank products that could lead to reputational risk—such as secured credit cards that promote high fees and interest rates to vulnerable populations.
So, combined with the challenge of moving low income and/or high credit risk individuals up the financial institution value chain, banks ended up focusing their efforts on debit cards, which solve some consumer pain points, but don't enable users to build their credit files or access needed credit.

**Today, however, companies like Galileo Financial Technologies are revisiting secured credit cards as a potentially powerful new tool for fintechs to tackle the issue of credit access among their customer base while expanding their addressable market.**

By reengineering the way these cards are structured and implemented, Galileo is helping clients overcome the problems associated with legacy secured credit cards for consumers and providers.

To understand more about the size and importance of the opportunity, this report dives deeper into the "credit access" market to identify who it impacts and what's needed to address the problem. We then discuss how re-engineered products can be used to meet the needs of this underserved segment of the population to significantly expand the addressable consumer credit market.

# Access to Credit

Access to credit is a fundamental economic building block that enables individuals to pursue economic opportunities and enjoy financial security. Today, credit history serves an essential passport to the U.S. economy. Increasingly, organizations require credit checks for a variety of reasons, including job applications, background checks and underwriting for numerous products and services. As a result, having a good credit file or history is critical.

## Addressable Market

Up to 121 million individuals with major representation among these demographic segments: [6]

Nearly 10 million Hispanic individuals and 8 million African-Americans who are credit invisible or "unscorable" due to lack of sufficient credit history.

1 million+ military servicemembers and recent veterans have fair to poor credit scores or lack a credit card.

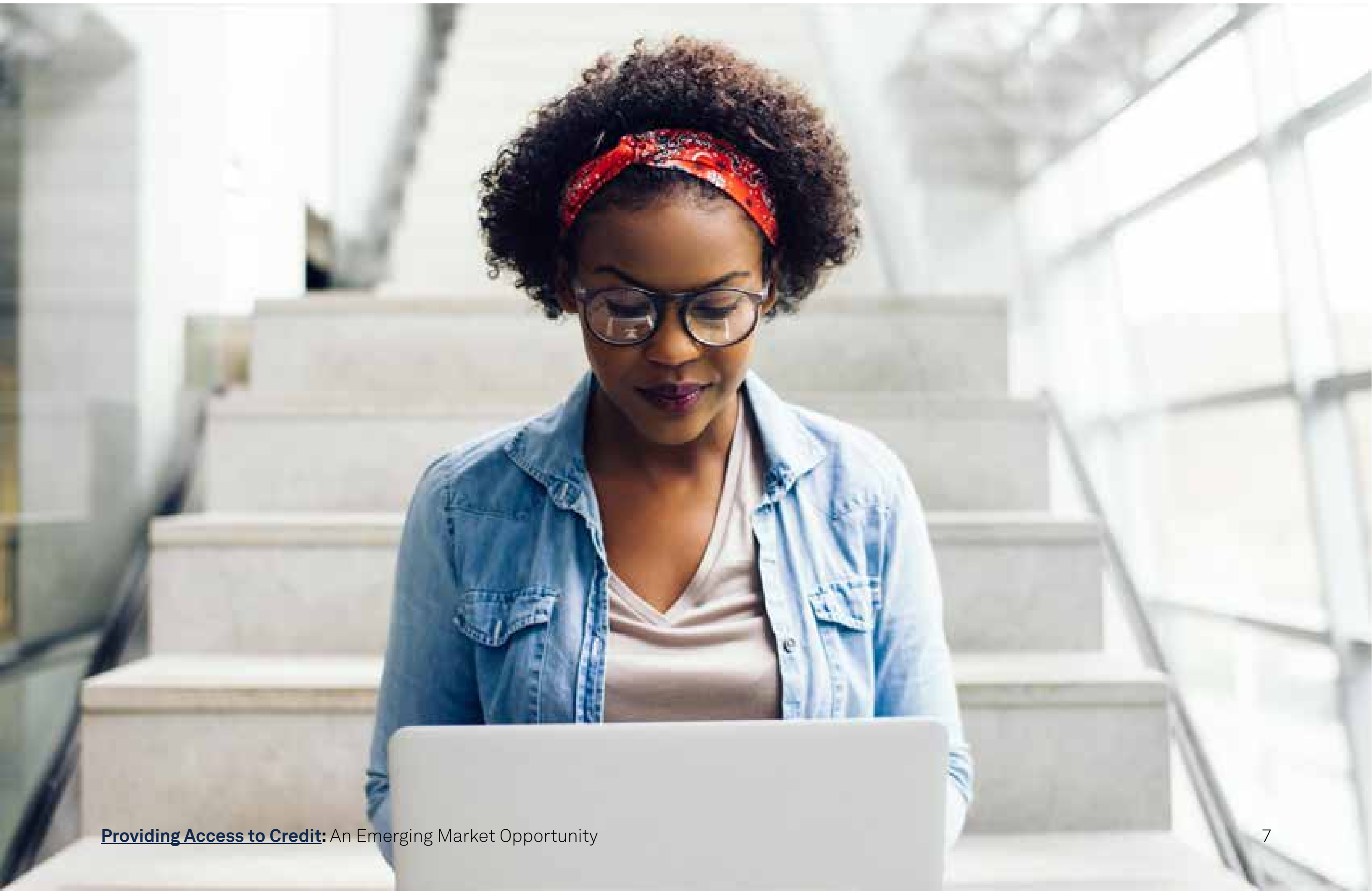
10 million, or nearly a third of adult Americans living outside metropolitan areas, have poor to fair credit scores.

More than 6 million immigrants, including international professionals, have fair to poor credit scores or lack a credit card.

The Financial Health Network, formerly known as The Center for Financial Services Innovation (CFSI), estimates that as many as 121 million individuals in the United States are credit challenged, with subprime credit scores (68 million) or thin or no credit files (53 million).[7] A similar **study by the Consumer Financial Protection Bureau** (CFPB) finds that as many as 45 million U.S. consumers, the so-called "credit invisibles," essentially have no credit scores with national reporting agencies. Several segments within these groups have been identified as needing credit-building products. These are:

**Young people:** According to the CFPB, more than 80% of those 18 and 19 years old (Generation Z) were credit invisible or did not have a recorded credit score, largely because they hadn't enough years to establish a credit history. That figure fell to below 40% for those ages 20 to 24. A recent study by Experian[8] found that credit scores for Millennials lagged considerably behind the national average. It's not surprising then that, according to a recent Forbes article[9], one in three Millennials, a quarter of Gen Xers and one in five Gen Zers expressed strong interest in credit-builder credit cards.

**Recent immigrants:** When immigrants leave their country of origin to come to the United States, they typically leave their credit history behind. This negates any creditworthiness they may have already established, and, as a result, they resemble younger Americans who have thin to no credit files. According to the Financial Health Network, more than 6 million immigrants have fair to poor credit scores or lack a credit card. International professionals and digital nomads also fall into this category.



**People of Color:** Only 23% of African-Americans and 22% of Hispanics are financially healthy, compared with 50% of white individuals.[10] Many factors contribute to this stark gap, including racial inequities and policies that advantage wealthier Americans, who tend to be white. The Financial Health Network estimates that nearly 10 million Hispanic individuals and 8 million African-Americans are credit invisible or unscorable due to lack of sufficient credit history.

**Active Duty Military and Veterans:** Compared to 44% of civilians, only 35% of active military service members are financially healthy and, on average, have more consumer debt and lower self-reported credit scores than civilians.[11] The Financial Health Network estimates that more than 1 million military servicemembers and recent veterans have fair to poor credit scores or lack a credit card.

**Rural Americans:** Rural residents lag their metropolitan counterparts in their overall financial health, with the bulk of high-poverty counties in the United States are located in rural areas. Over 62% of individuals who live in rural communities are financially struggling and 26% have subprime credit scores, compared with 55% and 21% respectively for urban residents.[12] They also have lower incomes on average. What's more, the data found that nearly a third of adult Americans living outside metropolitan areas (10 million), have poor to fair credit scores.

# Enter The Secured Credit Card

The traditional secured credit card is a type of payment card that requires a cash deposit in a special account, which serves as collateral for the card issuer in the event the cardholder can't make payments. The cash deposit isn't accessible to the borrower for spending or payments but stays in reserve until default or the account is closed.

The credit limit is often equal to 50% to 100%[13] of the amount of the initial deposit. If users apply for a secured credit card and put down a $1,000 deposit as collateral, for example, they'll likely qualify for a $500 to $1,000 line of credit. After making the initial deposit, they can use the card to make purchases in-person or online up to their credit limit.

### Secured credit cards often come with fees and high interest rates on revolving balances.

Nearly all have annual fees, and some charge monthly maintenance fees. Once cardholders pay off their balance for any recent purchases, they can use the card again to make more purchases. If they don't pay off their balance in full each month, they incur interest on the carried balance, similar to an unsecured card.

### When it comes to building a credit score, secured credit cards use the same process as unsecured cards.

The provider reports information regarding usage and payment history on the account to the major credit bureaus, which helps cardholders build credit and improve their credit rating over time.

The process of acquiring a secured credit card is relatively straightforward. The user applies to a financial institution and if accepted makes a cash deposit. The bank then issues the card. The new cardholder can use the card to make purchases to build a credit file by making payments on time.

# Trouble in Secured Credit Paradise

Secured credit fills a clear gap and has worked well for some consumers. However, the current structure of credit creates potential dramatic downsides, particularly for those who, arguably, could benefit from them the most.

Case in point, a consumer applies for a secured credit card and is approved, but an emergency comes up and they no longer have the funds to make the deposit. As a result, the card is cancelled by the provider, and the applicant suffers a strike against their credit.

In a second scenario, the consumer applies for the card and is approved. However, they are living paycheck to paycheck and the deposit creates a shortfall; one that the consumer must now make up with credit. As a result, they find themselves in a continuous debt cycle, where any issue could lead them to pay a higher annual percentage rate (APR) or fall behind.

In the third case, the consumer applies for the card and is approved. A medical emergency comes up and they are unable to make their payment. Their credit takes a hit, despite the fact that the bank has their collateral funds on hand, and they are charged additional fees, and, of course, interest.

Finally, consider the case where the consumer applies for the card and is approved. They consistently make their payments on time and build up their credit file. As a result of their success, the consumer is offered and accepts an unsecured credit card. They cancel the old secured card—their oldest credit account—in order to free up their deposit. Unfortunately, this results in a hit to their credit file.

# Reimagining Secured Credit

While legacy secured credit is problematic, the need for it continues to grow. In fact, several big banks, including JPMorgan Chase, Wells Fargo and U.S. Bank, announced in May[14], a plan to offer credit card products to those who lack a traditional credit score but could otherwise be shown to be financially responsible. By moving away from traditional credit scores, the banks can expand the addressable market and extend credit to those with thin or no credit files, including younger consumers, and immigrants.

Rather than pursuing alternative data sources, Galileo began by questioning the traditional structure of secured credit card agreements.

Instead of making a few feature tweaks or changes to terms, we completely revamped our secured credit product. The revamp gives vulnerable and ignored populations a credit-building product that accounts for their unique needs and situation.

Now consumers can access much-needed credit-building tools and purchasing power without the high fees (and regulatory scrutiny) associated with secured cards of the past. Galileo's novel approach to secured credit has resonated quickly with fintech clients who are dedicated to expanding financial inclusion and creating more value for their customers.

At the same time, offering an innovative secured credit product opens up market opportunities while providing better unit economics. It's a competitive market for those looking for new ways to grow their customer base while reinforcing value for current customers. Fintechs now have a critical solution in their suite of financial services products — Galileo's secured credit innovation.

# About Galileo

Galileo's cloud-based tech platform expands the financial frontier for fintechs, financial institutions and other businesses offering digital banking and other bank-like services. Our powerful APIs are the building blocks for financial services innovation, enabling clients to launch fast, grow rapidly and achieve scale. We further absorb the complexity of payments with our bank-grade back-office support and unmatched connectivity to payments networks, issuing financial institutions, ATM and load networks, and mobile wallet providers.

Our clients are a global who's who in financial services innovation, including leading neobanks operating from the United States and Canada, major fintech players in Mexico and international powerhouses with U.S.-based operations. Our clients also include emerging and established fintechs that are the superstars of the future and other types of businesses aspiring to go digital.

We don't play at financial services innovation. We live it and we deliver it. Let us do the heavy lifting, so you can focus on creating amazing user experiences for your customers.

Headquartered in Salt Lake City, Galileo has offices in Mexico City, New York City and San Francisco.

Put our relentless drive for client success to work for you: **https://www.galileo-ft.com/contact-us/**

## Endnotes

1 Financial Health Network, formerly known as The Center for Financial Services Innovation (CFSI), "**The Secured Credit Card Pathway: Opportunities in Serving Key Demographics**," July 2017

2 Calculation is based on 121 million individuals with thin or poor credit and their estimate that approximately 6 million secured credit cardholders used their cards to purchase, on average, $8,100 annually.

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10 Financial Health Network, formerly known as The Center for Financial Services Innovation (CFSI), "**The Secured Credit Card Pathway: Opportunities in Serving Key Demographics**," July 2017.

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14 Editorial team, **Banks Toy With Dumping Credit Scores from Lending Decisions**, The Financial Brand May 25, 2021

* Financial Health Network, formerly known as The Center for Financial Services Innovation (CFSI), "**The Secured Credit Card Pathway: Opportunities in Serving Key Demographics**". Calculation is based on 121 million individuals with thin or poor credit and CFSI's estimate that approximately 6 million secured credit cardholders used their cards to purchase, on average, $8,100 annually.

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