

The Financial Inclusion Trilemma

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The challenge of financial inclusion is among the most intractable policy problems in banking. Despite living in the world's wealthiest economy, many Americans are shut out of the financial system. Five percent of American households lack a bank account, and an additional thirteen percent rely on expensive and sometimes predatory fringe financial services, such as check cashers or payday lenders.

Financial inclusion presents a policy trilemma. It is possible to simultaneously achieve only two of three goals: widespread availability of services to low-income consumers, fair terms of service, and profitability of service. Thus it is possible to provide fair and profitable services, but only to a small, cherry-picked population of low-income consumers. Conversely, it is possible to provide profitable service to a large population, but only on exploitative terms. Or it is possible to provide fair services to a large population, but not at a profit.

The financial inclusion trilemma is not a market failure. Instead, it is the result of the market working. The market result, however, does not accord with policy preferences. Rather than addressing that tension, American financial inclusion policy still leads with market-based solutions, soft government nudges, and the hope that technology will transform the economics of small-balance deposit accounts and small-dollar loans.

It is time to recognize the policy failure in financial inclusion and consider to a menu of stronger regulatory interventions: hard service mandates, taxpayer subsidies, and public provision of financial services. In particular, this Article argues for following the approach taken in Canada, the European Union, and the United Kingdom. This approach—the adoption of a mandate for the provision of free or low-cost basic banking services to all qualified applicants—is the simplest solution to the problem of the unbanked. Addressing small-dollar credit, however, remains an intractable problem, largely beyond the scope of financial regulation because the challenge many low-income consumers face is solvency, not liquidity.

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Introduction

For half a century, the United States has failed at financial inclusion. Despite antidiscrimination laws, soft mandates to provide services to underserved populations, a proliferation of financial technology, and a generally booming economy, a sizeable share of the U.S. population remains without access to mainstream financial services from banks.

Nearly one in twenty U.S. households are “unbanked,” meaning that no member of the household has a bank account,¹ a much higher rate than in other developed countries.² Additionally, many households that have bank accounts are “underbanked,” meaning that they use alternative financial services for payments and small-dollar, short-term credit, such as check cashers, money orders, pawn shops, auto title loans, payday loans, earned wage access, or tax refund advances.³ Overall, over one in eight U.S. households with bank accounts is underbanked.⁴

The unbanked and underbanked populations in the United States are predominantly lower-income, with the unbanked population concentrated among those households earning less than \$30,000 annually, and the underbanked population concentrated among those households earning less than \$50,000 annually.⁵ Given correlations between income and race, it should be no surprise that a much higher percentage of minority populations is unbanked or underbanked. Nearly one in nine Black households and one in eleven Hispanic households lack a bank account,⁶ and nearly one in four Black and Hispanic households are underbanked.⁷ Yet even among lower-income populations, minority households are unbanked at a much higher rate than white households. While 3.31% of

1. *FDIC National Survey of Unbanked and Underbanked Households*, FED. DEPOSIT INS. CORP. 1 (2021) [hereinafter *FDIC 2021 Study*], <https://www.fdic.gov/analysis/household-survey/2021report.pdf> [<https://perma.cc/2VY4-PEG8>].

2. Luca Ventura, *World’s Most Unbanked Countries 2021*, GLOB. FIN. (Feb. 17, 2021), <https://www.gfmag.com/global-data/economic-data/worlds-most-unbanked-countries> [<https://perma.cc/9X5E-C8G8>].

3. *Economic Well-Being of U.S. Households in 2021*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. 43 (May 2022) [hereinafter *Fed Study*], <https://www.federalreserve.gov/publications/files/2021-report-economic-well-being-us-households-202205.pdf> [<https://perma.cc/6QY2-8QUZ>]. The Federal Reserve uses a narrower definition of “underbanked” than the Federal Deposit Insurance Corporation (FDIC), which includes international remittances and rent-to-own services in its definition of alternative financial services. *Report on the Economic Well-Being of U.S. Households in 2018*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. 25 n.14 (May 2019), <https://www.federalreserve.gov/publications/files/2018-report-economic-well-being-us-households-201905.pdf> [<https://perma.cc/WLU5-3Q4M>].

4. *Fed Study*, *supra* note 3, at 44.

5. *Id.* at 44 tbl.11; *FDIC 2021 Study*, *supra* note 1 at 14, 77. The median U.S. household income in 2021 was \$76,330. Gloria Guzman & Melissa Kollar, *Income in the United States: 2022*, U.S. CENSUS BUREAU 1 (Sept. 2023), <https://www.census.gov/library/publications/2023/demo/p60-279.html> [<https://perma.cc/SQ2R-F8NX>].

6. *FDIC 2021 Study*, *supra* note 1, at 14.

7. *Id.* at 76. Because of the Federal Reserve’s narrower definition of underbanked, which excludes remittances, see note 3 above, the Federal Reserve finds a lower underbanked rate for Hispanic households. *Fed Study*, *supra* note 3, at 44 tbl.11.

below-median-income white households are unbanked, 12.29% of below-median-income Hispanic households and 14.1% of below-median-income Black households are unbanked.⁸ Black women, in particular, are more likely to be unbanked than any other group.⁹

Lack of a bank account limits these households' ability to fully participate in the modern economy and has significant repercussions for racial equity. Without a bank account, it is more onerous and costly to make and receive payment, meaning that the poor pay more,¹⁰ exacerbating wealth disparities. Moreover, without a bank account, certain transactions are all but impossible—purchasing airline tickets, renting a car, and making any sort of online purchase.

Being underbanked also imposes substantial costs on households. The cost of alternative financial services is substantially higher than that of mainstream, bank-provided financial services. For example, while a credit card might have an annual percentage rate (APR) of 24%, a payday loan might have an APR as high as 662%.¹¹ Other types of short-term, small-dollar credit are similarly expensive.

Because the underbanked pay more to borrow, their net financial position is often worse off than if they had used mainstream financial services, but such mainstream services are not available to many underbanked households because of poor or limited credit histories. Once again, the racial disparities are stark, although they do not correlate as strongly with income. While 9.3% of white households are underbanked, 24.7% of Black households and 24.1% of Hispanic households are underbanked.¹² Again, Black women are the most likely to be underbanked, with nearly half using alternative financial services.¹³

This Article argues that the United States has failed at financial inclusion because it refuses to recognize an economic reality: it is not possible for financial institutions to profitably provide low-income consumers with financial services on non-exploitative terms at scale. The problem the United States faces is what this Article terms the “financial

8. Author's analysis of underlying data from *FDIC 2021 Study*, *supra* note 1.

9. Vicki L. Bogan & Sarah E. Wolfolds, *Intersectionality and Financial Inclusion in the United States*, 112 AEA PAPERS & PROC. 43, 43 (2022).

10. See generally DAVID CAPLOVITZ, *THE POOR PAY MORE: CONSUMER PRACTICES OF LOW-INCOME FAMILIES* (1967) (documenting how low-income households pay more for a range of goods and services than middle- or higher-income households).

11. *Red Alert Rates: Annual Percentage Rates on \$400, Single-Payment Payday Loans in the United States*, CTR. FOR RESPONSIBLE LENDING 3 (June 2023), <https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-red-alert-rates-payday-ratecap-map-jun2023.pdf> [<https://perma.cc/CZ8E-R32X>] (listing 662% annual percentage rate (APR) for Texas).

12. *FDIC 2021 Study*, *supra* note 1, at 76.

13. Bogan & Wolfolds, *supra* note 9, at 44. There are also correlations of age, gender, marital status, and education with the use of alternative financial services. Julie Birkenmaier & Qiang Fu, *The Association of Alternative Financial Services Usage and Financial Access: Evidence from the National Financial Capability Study*, 37 J. FAM. ECON. ISSUES 450, 450 (2015).

inclusion trilemma.” A policy trilemma is a situation in which only two of three policy goals can be simultaneously achieved.¹⁴

The financial inclusion trilemma means that it is possible to simultaneously achieve only two of three desired policy outcomes in the provision of financial services:

- (1) widespread availability of services to low-income consumers;
- (2) fair terms of service; and
- (3) stand-alone profitability of those services for service providers.

Thus, it is possible to provide fair and profitable services to a small, cherry-picked population of low-income consumers. Conversely, it is possible to provide profitable service on a wide scale, but only on exploitative terms. Or it is possible to provide fair services to a large population, but not with the service being profitable on a stand-alone basis. The golden trifecta of policy goals, however, is simultaneously unattainable.

The financial inclusion trilemma is not a market failure. Instead, it is an example of markets working precisely as expected. The problem is that the market, left to its own devices, will not produce the desired policy outcome of fair and widely available services absent some form of subsidization. To the extent there is a failure here, then, it is a failure of government to intervene when the market fails to produce the desired policy outcome.¹⁵

Addressing this policy failure will involve making tradeoffs among the policy goals. If low-income consumers are able to access fair products, it will come at the expense of financial institutions, while if financial institutions are able to be profitable, it will come at the expense of consumers through either lack of product access or unfair product terms.

14. Other examples of policy trilemmas include one in international economics among a fixed foreign exchange rate, free movement of capital across borders, and independent national monetary policy, see Maurice Obstfeld, Jay C. Shambaugh & Alan M. Taylor, *The Trilemma in History: Tradeoffs Among Exchange Rates, Monetary Policies, and Capital Mobility*, 87 REV. ECON. & STAT. 423 (2005); health care’s “iron triangle” among access, quality, and cost containment, see WILLIAM KISSICK, *MEDICINE’S DILEMMAS: INFINITE NEEDS VERSUS FINITE RESOURCES* 2 (1994); and one in financial regulation among provision of clear rules, maintenance of market integrity, and encouragement of financial innovation, see Chris Brummer & Yesha Yadav, *Fintech and the Innovation Trilemma*, 107 GEO. L.J. 235, 242 (2019).

15. See Mark V. Pauly, *Trading Cost, Quality, and Coverage of the Uninsured: What Will We Demand and What Will We Supply?*, in *THE FUTURE U.S. HEALTHCARE SYSTEM: WHO WILL CARE FOR THE POOR AND UNINSURED?* 353, 364-65 (Stuart H. Altman, Uwe E. Reinhardt & Alexandra E. Shields eds., 1998) (“[T]he worsening of the lot of the uninsured under market competition, if it occurs and is not offset by government, would not be an example of market failure. Rather, it would be an example of serious ‘government failure’ (at least in the sense of citizens collectively making a bad decision), an example of political failure, and perhaps of moral failure. Markets would be doing what they do best. It would be government that would be failing to do what it should do. Market competition will have abolished a type of charity that citizens, when faced with the challenge to pay for it explicitly and consciously, determined to be not worth its cost.”).

For too long, financial inclusion policy in the United States has proceeded on the assumption that a market solution to the trilemma would emerge, facilitated by technological advances and soft governmental nudges. Unfortunately, this is an unrealistic, but politically convenient conceit. Instead, this Article argues, if the United States wants to succeed at financial inclusion, it needs to consider more muscular interventions: hard service mandates, public provision, or taxpayer subsidies.

Hard service mandates, such as a requirement that banks offer free or low-fee basic bank accounts to all applicants, achieve financial inclusion by imposing a cross-subsidy on bank customers. Because banks are required to offer a service that is not otherwise profitable, they must fund it through either higher charges to other customers or accept lower overall profits, meaning lower returns for their shareholders. Such hard service mandates for basic bank accounts exist in Canada, the European Union, and the United Kingdom.¹⁶

Public provision entails either direct governmental provision of financial services or the use of governmental contractors, while subsidization means that taxpayers are funding private provision outside the government contracting process. There are trade-offs among these approaches, but all of them slice through the Gordian Knot of the trilemma by eliminating the stand-alone profitability condition.

All of these interventions, however, look quite different when applied to the problem of the unbanked, as opposed to the problem of the underbanked. Service mandates or public provision of deposit accounts raise materially different issues than service mandates or public provision of credit. There is substantially less financial risk involved in the provision of deposit accounts than the provision of credit. Moreover, the provision of credit, even if intermediated, puts the government into the uncomfortable and unsustainable business of allocating credit in the economy. If government allocates capital, eventually political pressure will push for unsustainable allocations to politically favored constituencies, rendering the banking system a giant political slush fund. Additionally, credit necessitates collections, which is an awkward fit for public provision, because it puts the government in an adverse role to those very consumers it seeks to help.

Interventions in the form of service mandates or public provision are appropriate for deposit accounts as well as for large-dollar credit, such as mortgages and student loans, which have positive social externalities and can be net positive financial and human capital investments. Such interventions are not appropriate, however, for small-dollar credit, like the majority of credit products used by the underbanked. Small-dollar credit—loans of hundreds or low thousands of dollars—is generally used for

16. See *infra* notes 167-180 and accompanying text.

liquidity management and for covering unexpected expenses. It is not used to pursue value-creating investments, nor does it have positive social externalities. In small-dollar credit markets, the trilemma must hold, forcing a policy choice between access to credit and fair terms of service.

While a large microfinance and development economics literature exists on various aspects of financial inclusion, most of it focuses on developing countries. There is a limited body of scholarship on financial inclusion in the United States.¹⁷ Within that limited literature, there has been remarkably little introspection as to why financial inclusion policy in the United States has overall been a failure over the past half century. To be sure, there have been some modest gains in American financial inclusion, particularly during several recent years when there was a booming economy and high levels of employment, but the United States still lags behind most of the developed world on financial inclusion metrics.¹⁸ The literature has mainly documented the financial inclusion problem, proposed particular solutions, or considered the effects of consumer protection regulation on deposit account and credit availability without holistic consideration of the nature of the policy problem. There is no literature that engages with tradeoffs among the different possible approaches to financial inclusion in terms of private and public provision. This Article represents a first attempt to address this gap in the literature.

In so doing, this Article makes three signal contributions to the literature. First, it identifies the financial inclusion trilemma as the fundamental nature of the policy problem. Once the trilemma is recognized, the policy response menu shifts from reliance on the market and light governmental interventions to more substantive governmental interventions.

17. See, e.g., LISA SERVON, *THE UNBANKING OF AMERICA: HOW THE NEW MIDDLE CLASS SURVIVES* (2018); JONATHAN MURDOCH & RACHEL SCHNEIDER, *THE FINANCIAL DIARIES: HOW AMERICAN FAMILIES COPE IN A WORLD OF UNCERTAINTY* (2017); MEHRSA BARADARAN, *HOW THE OTHER HALF BANKS: EXCLUSION, EXPLOITATION, AND THE THREAT TO DEMOCRACY* (2015); MICHAEL S. BARR, *NO SLACK: THE FINANCIAL LIVES OF LOW-INCOME AMERICANS* (2012); *INSUFFICIENT FUNDS: SAVINGS, ASSETS, CREDIT AND BANKING AMONG LOW- AND MODERATE-INCOME HOUSEHOLDS* (Rebecca M. Blank & Michael S. Barr eds., 2011); *BUILDING INCLUSIVE FINANCIAL SYSTEMS: A FRAMEWORK FOR FINANCIAL ACCESS* (Michael S. Barr, Anjali Kumar & Robert E. Litan eds., 2007); Jennifer L. Dlugosz, Brian T. Melzer & Donald P. Morgan, *Who Pays the Price? Overdraft Fee Ceilings and the Unbanked*, FED. RES. BANK OF N.Y. (2023), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr973.pdf [<https://perma.cc/5Y9W-THYJ>]; Bogan & Wolfolds, *supra* note 9; Birkenmaier & Fu, *supra* note 13; Mehrsa Baradaran, *It's Time for Postal Banking*, 127 HARV. L. REV. F. 165 (2014); Sherrie L.W. Rhine & William H. Greene, *Factors That Contribute to Becoming Unbanked*, 47 J. CONSUMER AFFS. 27 (2013); Leslie Parrish & Josh Frank, *An Analysis of Bank Overdraft Fees: Pricing, Market Structure, and Regulation*, 45 J. ECON. ISSUES 353 (2011); Michael S. Barr, *Credit Where it Counts: The Community Reinvestment Act and Its Critics*, 80 N.Y.U. L. REV. 513 (2005); Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REGUL. 121 (2004); Jeanne M. Hogarth, Chris E. Anguelov & Jinkook Lee, *Why Don't Households Have a Checking Account?*, 38 J. CONSUMER AFFS. 1 (2004).

18. Ventura, *supra* note 2.

Second, the Article explains why financial inclusion faces a trilemma. The problem stems from the small size of the financial transactions undertaken by lower-income consumers: these consumers maintain small deposit account balances, and their liquidity borrowing is for small dollar amounts. It is difficult for financial services businesses to amortize fixed and semi-variable expenses like overhead over small transaction amounts, so their fees and charges are necessarily large relative to the transaction amount. These high costs are the foremost barrier to financial inclusion.

Third, this Article underscores the critical difference in policy approaches required for the problem of the unbanked and the problem of the underbanked. The unbanked and underbanked are fundamentally different populations, both in terms of their economic profile and the nature of the inclusion problem. While the unbanked are all necessarily underbanked, many of the underbanked are not unbanked. Instead, the primary characteristic of the underbanked is that they have poor credit.

Unfortunately, both policy discussions and the scholarly financial inclusion literature often lump the unbanked and the underbanked together. For example, discussions of postal banking and proposed legislative implementations are often framed as a policy solution to both the problem of the unbanked and the high costs of payday lending,¹⁹ but this framing fails to recognize that it is impossible to get a payday loan without a bank account. There is no such thing as an unbanked payday borrower. Providing postal bank accounts to unbanked consumers would not reduce payday lending, but might in fact *increase* it by making more consumers eligible to get payday loans. Recognition of the substantially different nature of the unbanked and underbanked problems is necessary for tailoring effective policy solutions to each.

The Article proceeds in four parts. Part I reviews the nature of the financial inclusion problem in the United States. In particular, it focuses on the very different nature of two financial inclusion subproblems: the unbanked and the underbanked. Frequently, policy discussions treat these groups as interchangeable, when they are in fact substantially different both in their economic situation and in the nature of the financial inclusion problem they face.

Part II introduces the nature of the financial inclusion trilemma. Using the economics of deposit accounts and payday loans, it shows that the cost structure of small-dollar transactions makes it impossible to profitably serve low-income consumers on scale, except by engaging in exploitative practices.

19. See, e.g., Baradaran, *supra* note 17, at 167 (noting that postal banks could offer lower-cost payday loans); *Providing Non-Bank Financial Services for the Underserved*, OFF. OF INSPECTOR GEN., U.S. POSTAL SERV. 12-14 (Jan. 27, 2014), https://www.uspsaig.gov/sites/default/files/reports/2023-01/rarc-wp-14-007_0.pdf [<https://perma.cc/D62P-X5HE>] (proposing short-term, small-dollar credit provision through the post office); Postal Banking Act, S. 4614, 116th Cong. (2020) (proposing provision of small-dollar loans via the post office).

Part III turns to a consideration of the alternative approaches to financial inclusion: reliance on private provision, including technological advances; soft mandates; hard mandates (cross-subsidies); public options; and public subsidies. The United States has historically relied on private provision coupled with soft mandates, such as the Community Reinvestment Act, and antidiscrimination laws. This approach has failed because private provision, even bolstered by technological advances through fintech, has been unable to materially change the economics of deposit accounts or small-dollar lending. Financial inclusion is a problem precisely because the market works as expected.

Part IV argues that achieving financial inclusion requires greater regulatory intervention, but that success is possible only for the problem of the unbanked. While a hard mandate of free or low-cost bank account provision is the best solution to the problem of the unbanked, the problems of the underbanked cannot be addressed through public provision or service mandates. Instead, small-dollar credit policy requires making difficult choices about which two goals of the policy trilemma ought to be prioritized.

I. The Financial Inclusion Problem in the United States

The financial inclusion problem in the United States has two separate aspects: the unbanked and the underbanked. It is important to understand that these are distinct populations with different financial inclusion problems.

A. The Unbanked

The unbanked lack any sort of deposit account relationship with a bank. Bank deposit accounts are important to consumers for two reasons. First, they are a vehicle for the safekeeping of funds. And second, deposit accounts are the launchpad for many types of payments. A deposit account is required for making payments by automated clearing house (ACH) (including via Zelle), check, and debit card, because those payments are directly debited from a bank account. A bank account is also generally necessary for making payments by credit card because the credit card bill must be paid, and cannot be paid in person with cash.

Similarly, electronic payment systems like PayPal and Venmo allow funds to be transferred among users without requiring a bank account, but the initial loading of funds must either be from a bank account, a credit card, or a payment from another user. This means that unbanked PayPal and Venmo users are limited to transacting with balances that they have received from other PayPal and Venmo users, and that they can transact only with those who accept PayPal or Venmo (respectively) as a form of payment.

When the unbanked want to receive non-cash funds, they must either use a check casher or a prepaid card, both of which have comparatively high fees. In contrast, there is usually no marginal cost to the consumer for receiving a payment in a bank account. Likewise, when the unbanked wish to send funds, such as for paying bills or for remittances to family abroad, they must purchase money orders or use money transmitters like Western Union. All of these services come with a fee. In contrast, there is no marginal fee to send funds from a bank account via ACH. Receiving and sending payments thus costs more for the unbanked.

Nor is the higher cost of payments the only cost of being unbanked. Because credit cards, and secondarily ACH and debit cards, are the main payment methods accepted for online transactions, unbanked consumers have limited ability to transact online, meaning that they have limited ability to participate in the modern commercial world. In practical terms, being shut out of online commerce limits consumers to shopping at brick-and-mortar retailers.

For low-income consumers, the situation is particularly problematic. Transportation costs and time restrictions effectively limit most low-income consumers to shopping primarily at local neighborhood retailers. When low-income consumers live in neighborhoods served by only one or two retailers, they are likely to have to pay supracompetitive prices to local monopolies, like the only grocery store or hardware store in the neighborhood—if they can find the goods they want at all. Being unbanked can result in higher costs of goods and services because it limits the competition for the consumer's business.

There are numerous reasons that consumers are unbanked. The Federal Deposit Insurance Corporation (FDIC) has repeatedly surveyed consumers about why they are unbanked. The leading reason given by respondents is not having enough money to meet minimum balance requirements, followed by not trusting banks.²⁰ Other reasons given include the desire to maintain privacy; excessively high or unpredictable bank account fees; problems with personal identification, credit, or former bank accounts; banks not offering the desired products or services; and inconvenient bank locations.²¹

Although the FDIC survey responses are the go-to source for the reasons that consumers are unbanked, the survey responses should be taken with a grain of salt. They are self-reported survey responses and thus may reflect how respondents wish to present themselves, rather than the truth. For example, a respondent with bad credit, who has been repeatedly turned down in attempts to open a bank account, might not wish to admit

20. *FDIC 2021 Study*, *supra* note 1, at 3.

21. *Id.*

to having bad credit,²² but might instead point to other factors, like failure to meet minimum balance requirements, high or unpredictable fees, or mistrust of banks.

Additionally, the categories of responses in the FDIC surveys are hardly exclusive. Minimum balance requirements, for example, are typically tied to fees, so not having enough money to meet minimum balance requirements is really a variation on fees being too high or unpredictable and is likely correlated with having credit problems.

Still, taken as a whole, the FDIC surveys suggest that the phenomenon of the unbanked is multicausal, but that consumers' economic situation is the primary driver. Indeed, the FDIC found that approximately half of the decline in the unbanked rate from 2011 to 2021 was associated with improvements in households' socioeconomic circumstances.²³ This is not to say that other issues, like lack of identity documentation or cultural factors, do not play a role, but consumers' economic situation appears to be the single most important factor in the unbanked rate.

Not surprisingly, then, FDIC surveys indicate that Black and Hispanic Americans—on average lower-income populations²⁴—are substantially overrepresented among the unbanked. Figure 1, below, shows that much higher percentages of Black and Hispanic Americans are unbanked compared to Asian or white Americans.

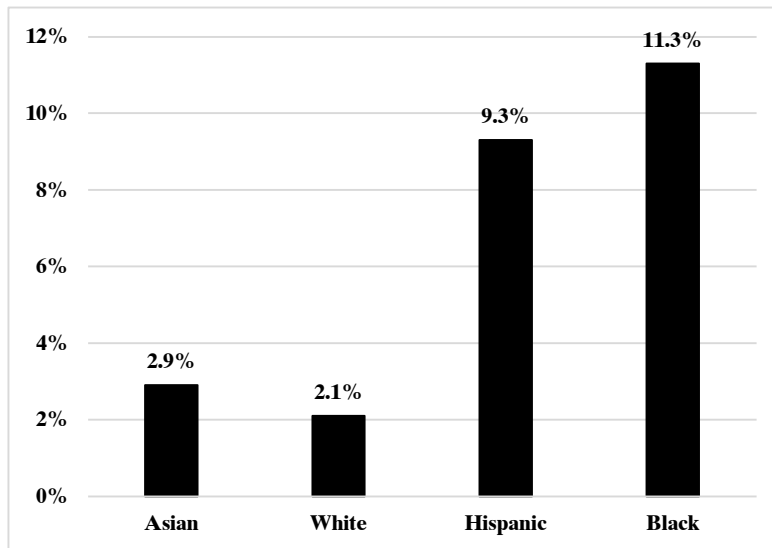
It is unclear whether these other factors are on the financial institution side or the household side. For example, on the financial institution side, factors that correlate with race could include discrimination against minority applicants, preference for credit scoring of applicants, or lack of service in minority communities. On the household side, correlations with race could include cultural attitudes toward banking, lack of credit scores,²⁵ or simply lack of familiarity with banks. For example, a person whose parents were banked is likely to be used to going to a bank, while a person whose parents were unbanked may be uncomfortable using banks because they are unfamiliar.

22. Banks are exposed to credit risk on deposit accounts due to the possibility of overdrafts. As a result, many banks require a credit screening, typically using Chex Systems, prior to opening an account.

23. *FDIC 2021 Study*, *supra* note 1, at 1.

24. Gloria Guzman & Melissa Kollarr, *Income in the United States: 2022*, U.S. CENSUS BUREAU 3 (Sept. 2023), <https://www.census.gov/content/dam/Census/library/publications/2023/demo/p60-279.pdf> [<https://perma.cc/RZP4-3DCL>] (listing median incomes for Asian households at \$108,700, non-Hispanic white households at \$81,060, Hispanic households of any race at \$62,800, and Black households at \$52,860).

25. *See, e.g., Data Point: Credit Invisibles*, CONSUMER FIN. PROT. BUREAU OFF. OF RSCH. 17-18 (May 2015), https://files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf [<https://perma.cc/D3FV-5P69>] (providing evidence that Black and Hispanic consumers are more likely to lack credit records).

Figure 1. Percentage of Unbanked Households by Race²⁶

B. The Underbanked

The underbanked have deposit accounts at banks, but they use high-cost alternative financial services providers for credit and payments. In particular, they use small-dollar, short-term lenders, such as payday loans, vehicle title loans, pawn loans, tax refund anticipation loans, retail installment credit, buy-now-pay-later, rent-to-own, and small signature loans. These lenders charge high fees, but they also offer very fast or even immediate funding. The underbanked may also use check cashers despite having bank accounts due to convenience factors, such as longer business hours and more accessible locations, faster funds availability, or to avoid setoff of overdrafts or garnishment orders.²⁷

The unbanked are, by definition, also underbanked, but many of the underbanked have bank accounts. Indeed, many alternative financial services *require* the consumer to have a bank account. Payday loans, for example, require the borrower to have a bank account as part of the mechanism for collecting on the loans: the borrower gives the lender either a post-dated check or the authorization for an ACH draw on the account.

26. *FDIC 2021 Study*, *supra* note 1, at 14.

27. Some definitions of “underbanked” also include the use of money transmitters for foreign remittances. *See, e.g., Report on the Economic Well-Being of U.S. Households in 2019, Featuring Supplemental Data from April 2020*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. 27 n.26 (May 2020), <https://www.federalreserve.gov/publications/files/2019-report-economic-well-being-us-households-202005.pdf> [<https://perma.cc/4YMS-38Y5>].

Likewise, some types of alternative lending, particularly online lending, require a bank account where funds can be deposited.

The ultimate policy problem of the underbanked is substantially different than that of the unbanked. Whereas the unbanked are simply shut out of much of the commercial world, the underbanked are able to participate, but are spending more for credit than fully-banked consumers, which comes with a host of negative consequences.

The underbanked are not uniform in their reasons for using short-term small-dollar credit. Economic factors, however, are the driver of the underbanked phenomenon, even more than the unbanked phenomenon.²⁸ Because the underbanked (excluding the unbanked subpopulation) are, by definition, users of banks, they are not using high-cost alternative financial services because of lack of trust of financial institutions or lack of legal documentation. Instead, the underbanked are often strapped for liquidity, and alternative financial service providers are able to provide immediate liquidity—walk to the payday lender, pawnshop, or check casher and walk away with cash—in a way that traditional banks do not. Thus, several studies have found that payday borrowers either lack available credit card lines²⁹ or that they decrease their borrowing following a tax rebate.³⁰

For some borrowers, short-term, small-dollar credit products provide a liquidity bridge that help them deal with unexpected and immediate expenses that must be paid before income comes in. But for many borrowers, short-term, small-dollar credit only exacerbates their financial problems. These borrowers face solvency as well as liquidity problems.³¹ As one study notes, even if the loan is offered for “free,” meaning with no fee, “a typical borrower will be unable to meet his or her most basic

28. The possible exception here might be the use of check cashers to avoid garnishment, but this is a relatively small part of the underbanked phenomenon.

29. Neil Bhutta, Paige Marta Skiba & Jeremy Tobacman, *Payday Loan Choices and Consequences*, 47 J. MONEY, CREDIT, & BANKING 223, 234 (2015) (finding that payday borrowers have generally exhausted their credit lines at the time of their first payday loan application); Susan P. Carter, Paige M. Skiba & Jeremy Tobacman, *Pecuniary Mistakes? Payday Borrowing by Credit Union Members*, in FINANCIAL LITERACY: IMPLICATIONS FOR RETIREMENT SECURITY AND THE FINANCIAL MARKETPLACE 145, 148-49 (Olivia S. Mitchell & Annamaria Lusardi eds., 2011) (finding that payday loan borrowers who belonged to a credit union had about one-eighth the available liquidity of credit union members who did not take out payday loans, and that 70% of the borrowers had no available line of credit at the time of the loan). *See also* Neil Bhutta, Jacob Goldin & Tatiana Homonoff, *Consumer Borrowing after Payday Loan Bans*, 59 J.L. & ECON. 225, 227, 230 (2016) (finding that following payday lending bans consumers shift to other forms of high-cost credit, but not credit cards, suggesting that they do not have available credit card lines). *But see* Sumit Agarwal, Paige Marta Skiba & Jeremy Tobacman, *Payday Loans and Credit Cards: New Liquidity and Credit Scoring Puzzles?*, 99 AM. ECON. REV. PAPERS & PROC., 412, 412 (2009) (finding that payday borrowers have substantial line availability on their credit cards on the day of borrowing).

30. Paige Marta Skiba, *Tax Rebates and the Cycle of Payday Borrowing*, 16 AM. L. & ECON. REV. 550, 550 (2014) (finding that payday loan borrowing was reduced in the short term following the liquidity infusion of a tax rebate).

31. *See* Payday, Vehicle Title, and Certain High-Cost Installment Loans, 82 Fed. Reg. 54472, 54570 (Nov. 17, 2017) (summarizing research regarding high delinquency rates on credit cards and frequent nonsufficient funds fees incurred by payday borrowers).

obligations and repay the payday loan debt in a two-week period.”³² The high cost of short-term, small-dollar credit only deepens borrowers’ solvency problems. This leads to borrowers having to make painful consumption decisions, such as whether to repay a loan or meet basic expenses, such as food, childcare, and health care.

As a result, borrowers with short-term, small-dollar debt frequently “roll over” or extend their loans, or borrow in repeated sequences. Instead of being short term, the debt effectively becomes longer term, but it still bears the high cost associated with short-term lending. Ultimately, in part because of the high costs of short-term, small-dollar credit, many borrowers default on their obligations.³³

Defaults have collateral consequences for borrowers. They may result in additional fees from the lender and/or result in the borrower’s bank account becoming overdrawn—resulting in incursion of the bank’s overdraft or nonsufficient funds fees—and possible account closure. Thus, access to payday loans is associated with increased rates of involuntary bank account closures.³⁴ Additionally, the high cost of servicing short-term, small-dollar debt may result in the borrower becoming delinquent on other obligations.³⁵ In short, for many borrowers, rather than helping, short-term, small-dollar debt exacerbates their financial problems.

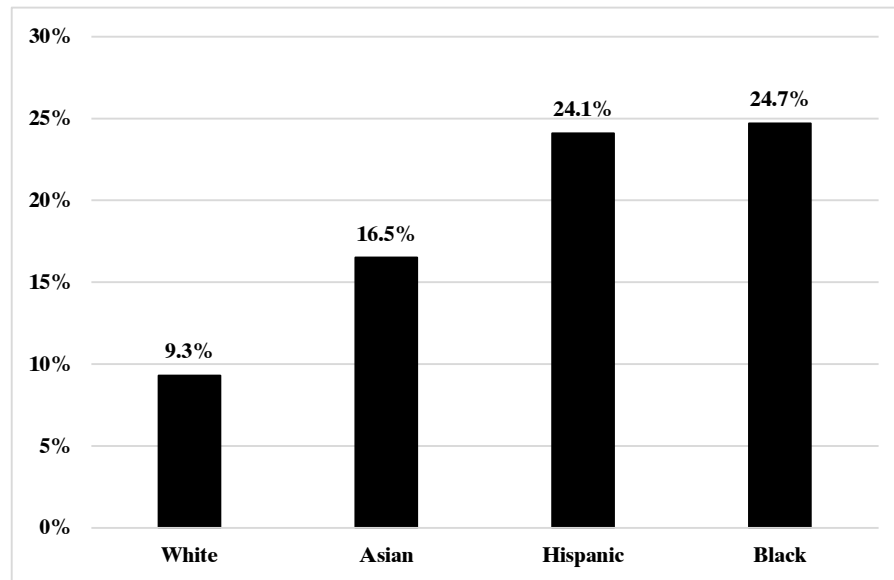
As with the unbanked, Black and Hispanic Americans are substantially overrepresented among the underbanked. Figure 2, below, shows that a much higher percentage of Black and Hispanic households are underbanked compared to Asian or white households.

32. Susanna Montezemolo, *The State of Lending in America & its Impact on U.S. Households*, CTR. FOR RESPONSIBLE LENDING 5 (Sept. 2013), <https://www.responsiblelending.org/sites/default/files/uploads/10-payday-loans.pdf> [<https://perma.cc/377Z-JF7W>].

33. See, e.g., Uriah King & Leslie Parrish, *Payday Loans, Inc.: Short on Credit, Long on Debt*, CTR. FOR RESPONSIBLE LENDING 19 (Mar. 31, 2011), <https://getoutofdebt.org/wp-content/uploads/2011/04/payday-loan-inc.pdf> [<https://perma.cc/7Y3W-SY3G>] (finding a 37% default rate for borrowers within the first year and 44% default rate within two years); Paige Marta Skiba & Jeremy Tobacman, *Payday Loans, Uncertainty and Discounting: Explaining Patterns of Borrowing, Repayment, and Default*, tbl.2 (Vand. L. & Econ. Rsch. Paper, Paper No. 08-33, 2008), <https://ssrn.com/abstract=1319751> [<https://perma.cc/X48G-ZB4A>] (estimating a 54% default rate at a large Texas-based payday lender); Susanna Montezemolo & Sarah Wolff, *Payday Mayday: Visible and Invisible Payday Defaults*, CTR. FOR RESPONSIBLE LENDING 4 (Mar. 2015), https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/finalpaydaymayday_defaults.pdf [<https://perma.cc/KJ8M-FPX9>] (estimating that 39% of new payday borrowers in North Dakota default within one year and 46% default within two years).

34. Dennis Campbell, F. Asís Martínez-Jerez & Peter Tufano, *Bouncing out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures*, 36 J. BANKING & FIN. 1224, 1225 (2012).

35. See, e.g., Agarwal et al., *supra* note 29, at 416 (finding that credit card users who began to borrow from payday lenders were 92% more likely to become delinquent on their credit card payments). It is unclear whether payday borrowing is the cause of the delinquency or if the turn to payday loans reflects general deteriorating financial condition. See Brian T. Melzer, *The Real Costs of Credit Access: Evidence from the Payday Lending Market*, 126 Q.J. ECON. 517, 534 (2011) (providing evidence that individuals with access to storefront payday loans were 25% more likely to have difficulty paying bills and 25% more likely to delay medical care than those without access).

Figure 2. Percentage of Underbanked Households by Race³⁶

It is important to note that the type of alternative financial services relied upon may vary across races. In particular, the FDIC data includes international remittance transactions,³⁷ which are most likely to be undertaken by immigrant populations sending funds back to family in their countries of origin. This contributes to a higher level of alternative financial service use for all populations, but is likely to contribute more to the figures reported by Asian and Hispanic households, partially explaining the high use of alternative financial services even by above-median-income Asian and Hispanic households.

Still, it is clear that Black and Hispanic households are far more likely to use alternative financial services for credit and payments than Asian and white households, even accounting for income. Yet controlling for income is not the same as controlling for credit. Credit scores have only a weak correlation with income,³⁸ but stronger correlation with race.³⁹ Thus, to the extent that minorities have lower credit scores, this may prevent them from obtaining bank credit and result in greater use of alternative financial services for credit provision. This can become a vicious cycle, because the higher costs of alternative financial services make defaults more likely on

36. *FDIC 2021 Study*, *supra* note 1, at 76.

37. *BD. OF GOVERNORS OF THE FED. RSRV. SYS.*, *supra* note 27, at 27 n.26.

38. Rachael Beer, Felicia Ionescu & Geng Li, *Are Income and Credit Scores Highly Correlated?*, FEDS NOTES (Aug. 13, 2018), <https://www.federalreserve.gov/econres/notes/feds-notes/are-income-and-credit-scores-highly-correlated-20180813.html> [<https://perma.cc/9UK2-UJ7K>].

39. *See, e.g.*, *CONSUMER FIN. PROT. BUREAU OFF. OF RSCH.*, *supra* note 25, at 17-18 (finding that Black and Hispanic consumers are more likely to be credit invisible).

consumer reporting obligations and thus diminish credit scores, pushing the consumers back towards using alternative financial services.

II. The Financial Inclusion Trilemma

Financial inclusion—meaning access to the formal banking system—has been recognized as a policy problem in the United States for decades,⁴⁰ although it only began to receive concentrated attention around the beginning of the twenty-first century.⁴¹ Financial inclusion is a distinct policy problem from access to mortgage credit, which has been the focus of federal regulatory interventions since the New Deal.⁴² Mortgage credit and homeownership have been a middle-class project that presupposes households being banked. A mortgage requires a borrower to first save up for a down payment, which is presumably kept in a deposit account, and to then make monthly payments from a bank account. Instead, financial inclusion as a policy matter has focused on the unbanked and the use of check cashers, money transmitters, and short-term, small-dollar lenders.

As noted in the introduction, financial inclusion involves a policy trilemma in which only two of three policy goals can be simultaneously achieved: widespread access, fair terms, and profitable provision.⁴³ Regulatory approaches have generally targeted one or another element of the financial inclusion trilemma without recognizing the nature of the trilemma, namely that interventions targeting one of the three elements force a choice between the other two elements.

For example, state laws that regulate the terms of financial service contracts, such as usury laws and laws restricting rollovers and renewal of loans, address the fairness problem. Such laws force a choice between widespread availability of small-dollar credit and the stand-alone profitability of those products. Generally, the result of increased regulation has been a contraction in the availability of small-dollar credit.⁴⁴ Likewise, deregulatory initiatives aimed at expanding access to credit inevitably

40. See, e.g., *The Fair Access to Check Cashing Act: Hearing on S. 2110 Before the Subcomm. on Consumer Affs. of the S. Comm. on Banking, Hous., & Urb. Affs.*, 100th Cong. (1988).

41. A Google n-gram for “financial inclusion” shows that the term was virtually unused prior to 2000.

42. See ADAM J. LEVITIN & SUSAN M. WACHTER, *THE GREAT AMERICAN HOUSING BUBBLE: WHAT WENT WRONG AND HOW WE CAN PROTECT OURSELVES IN THE FUTURE* 41-57 (2020).

43. See *supra* note 14 and accompanying text.

44. See, e.g., Colleen Honigsberg, Robert J. Jackson Jr. & Richard Squire, *How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment*, 60 J.L. & ECON. 673, 675 (2017) (noting that lenders responded to a change in usury law by extending less credit); Efraim Benmelech & Tobias J. Moskowitz, *The Political Economy of Financial Regulation: Evidence from U.S. State Usury Laws in the 19th Century*, 65 J. FIN. 1029, 1029 (2010) (finding that usury laws, when binding, reduced credit availability); John D. Wolken & Frank J. Navratil, *The Economic Impact of the Federal Credit Union Usury Ceiling*, 36 J. FIN. 1157, 1157 (1981) (finding that a usury ceiling reduces lending).

result in consumer protection problems because small-dollar credit cannot simultaneously be priced fairly and profitably on a stand-alone basis.

The financial inclusion trilemma is a theory that, like gravity, cannot be definitively proven, but its effects are nonetheless readily observable. This Part provides a pair of examples—the economics of bank accounts and of payday loans—that illustrate the challenge underlying financial inclusion, which typically involves small-dollar transactions in which economies of scale are not possible.

A. Illustration #1: The Economics of Deposit Accounts

Traditionally, deposit accounts were stand-alone financial products; a consumer could have a deposit account at a bank without having any other financial relationship with the bank. This enables an analysis of the economics of deposit accounts on a stand-alone basis. This illustration reviews the costs a bank incurs and the income it receives from a deposit account. It shows that small-balance accounts can be offered profitably on a stand-alone basis only if there is substantial direct fee income, for example, from overdraft fees.

1. Costs of Deposit Accounts

Banks incur expenses in opening and maintaining deposit accounts. Opening an account involves verifying the consumer's identity to comply with anti-money laundering regulations, running a credit check on the consumer, providing the consumer with various disclosures, and onboarding the consumer's information. Cost estimates here are necessarily imprecise and somewhat dated, but they still give a ballpark sense. A 2020 estimate indicates that it costs banks on average \$280 to onboard a new customer through brick-and-mortar infrastructure and \$120 to onboard a customer in a digital-only process.⁴⁵ These figures are roughly in line with a 2010 American Bankers Association estimate that it cost between \$150 and \$200 for a bank to open an account.⁴⁶

Maintaining an account also has costs. Some expenses are account-specific: the bank must pay federal deposit insurance premiums, provide periodic statements, make interest payments, and incur fraud losses. If a consumer overdraws and then abandons an account, the bank is left with the loss on the overdraft in the first instance; the ability to overdraft means

45. Vincent Bezemer, *Digital Onboarding and Origination: The Cure for Banks' Customer Acquisition Pains*, ABA BANK MKTG. (Aug. 11, 2020), <https://bankingjournal.aba.com/2020/08/digital-onboarding-and-origination-the-cure-for-financial-institutions-customer-acquisition-pains> [https://perma.cc/AH6V-WBFM].

46. *The Cost of a Checking Account*, AM. BANKERS ASS'N (June 2010) (on file with author).

any payment or withdrawal transaction from a deposit account creates credit risk for the bank.

Other expenses are in the nature of overhead. The bank must maintain technology systems that enable transfers in and out of the account and calculation of balances and funds availability; operate call centers, brick and mortar branches, and websites; and ensure regulatory compliance. That means paying for physical space and utilities, as well as compensation for employees. Additionally, the bank must engage in marketing to prospect for new customers.

Allocation of overhead expenses to accounts is again imprecise and varies with economies of scale, such that the marginal cost of an additional account might be substantially lower than the average cost.⁴⁷ The American Bankers Association estimated in 2010 that it cost between \$200 and \$300 annually for a bank to maintain an account.⁴⁸ Other sources estimate annual account maintenance costs ranging from \$175 to \$450, including all possible overhead.⁴⁹ Even admitting the imprecision and age of cost estimates of opening and maintaining a deposit account, and that these are average, not marginal costs, it should be clear that these costs are far from minimal.

2. Spread Income

Banks earn money on deposit accounts in three ways: interest rate spreads, direct fees, and indirect fees. The interest rate spread—also known as the “net interest margin”—is the difference between the interest the bank pays the depositor and what the bank is able to earn by reinvesting the deposit.

Banks consistently average net interest margins of around 3%.⁵⁰ This means that for small-dollar deposits, the interest spread is insufficient to cover the costs of maintaining the accounts. Lower-income consumers tend to have low and often negative balances, such that a bank cannot profitably offer them a deposit account based solely on spread income.

Consider an account with an average balance of \$100 over a year. If the bank makes a 3% net interest margin on the account, it will earn all of

47. Some overhead expenses are lumpy: a call center might have the capacity to handle each of 100,000 additional customers with little marginal cost, but once it reaches capacity, a new, expensive call center will be needed.

48. AM. BANKERS ASS'N, *supra* note 46. Other, older sources, however, put the price of account maintenance significantly lower, between \$48 and \$145 per year. FED. RSRV. BD., FUNCTIONAL COST & PROFIT ANALYSIS 129 (1997) (on file with author) (finding that the cost of a fully loaded account is \$145). *See also* Ralph Haberkamp, *Cognitive Dissonance, Microeconomics, and Checking Accounts*, BANKSTOCKS (Mar. 4, 2002), (on file with author) (estimating variable costs of \$48).

49. *Bank Accounts: More Fees Are Coming. How to Fight Back—or Flee.*, CONSUMER REPS. (Feb. 2012), <https://www.consumerreports.org/cro/magazine/2012/02/bank-accounts/index.htm> [<https://perma.cc/5Y9L-7VYT>].

50. *Quarterly Banking Profile: First Quarter 2021*, 15 FDIC Q. 1, 1 fig.2 (2021).

\$3 of spread on the account over the year. Three dollars of annual net revenue per account will come nowhere close to offsetting the bank's marginal or average operating costs per account. The monthly balance statements that have to be mailed at \$0.60 per stamp result in \$7.20 in annual postage costs alone. And this ignores the other costs associated with the mailing—paper, ink, labor—much less the other account-specific expenses or the share of overhead that must be attributed to the account.

Indeed, assuming a 3% net interest margin and \$200 in annual operating costs per account, a bank cannot profitably offer an account with a balance of less than \$6,667 solely on the basis of spread income. Account opening expenses must also be considered. To recoup an additional \$200 in account opening expenses over five years would require the consumer to maintain an average balance of \$8,000. In 2022, the median balance in a transaction account among families owning at least one asset (virtually all families) in the United States was \$8,000,⁵¹ so banks are unable to profitably serve half of banked households solely on spread income. Even if one assumes that three-quarters of the costs are attributable to overhead, such that they do not figure in the marginal costs of an additional account, the point still stands—a bank would not be able to recoup its costs based on spread income alone over five years from customers with average deposit balances of less than \$2,000.

It should be clear, then, that spread income alone is insufficient to enable a bank to profitably serve a low-balance customer. Instead, the bank must look to supplement the spread income with indirect or direct fee income or revenue from cross-selling other products. As the following sections discuss, indirect fee income, even when combined with spread income, is not sufficient to cover the costs of serving a low-balance consumer, while both direct fee income and cross-selling income pose fairness problems.

3. Indirect Fee Income

The funds in many deposit accounts are accessible through a debit card. Offering a debit card imposes some costs on banks, not least the provision of the card itself, but banks earn revenue in the form of “interchange fees” on every debit card transaction. The interchange fee is not charged directly to the consumer, but is instead a fee paid by the merchant's bank to the consumer's bank.⁵² Interchange fees are set by

51. Aditya Aladangady, Jesse Bricker, Andrew C. Chang, Sarena Goodman, Jacob Krimmel, Kevin B. Moore, Sarah Reber, Alice Henriques Volz & Richard A. Windle, *Changes in U.S. Family Finances from 2019 to 2023: Evidence from the Survey of Consumer Finances*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. 16 (Oct. 2023), <https://www.federalreserve.gov/publications/files/scf23.pdf> [<https://perma.cc/L8YB-B7V3>].

52. ADAM J. LEVITIN, CONSUMER FINANCE: MARKETS AND REGULATION 351-52 (2d ed. 2022).

debit card network associations,⁵³ but for larger banks—those with over \$10 billion in assets—the fees are capped by law.⁵⁴ The cap is currently set at \$0.21 plus 0.05% of the transaction value and a possible \$0.01 fraud prevention expense adjustment.⁵⁵

Interchange fees have for years been at the center of a ferocious antitrust fight between merchants and banks,⁵⁶ but unlike direct fees, they do not present immediate consumer protection problems. Debit interchange fees, however, are quite small per transaction. Given that the average-sized debit transaction in 2021 was only \$46,⁵⁷ the interchange revenue on the transaction would be a bit over \$0.24. Even if a consumer completed forty debit transactions every month for a year, the total interchange revenue on the account would be \$116.64, still not enough, in addition to spread income, to offset account operating costs, much less opening costs.

4. Direct Fee Income

A banking business model that relies on direct fee income is problematic because competitive dynamics incentivize banks to try to charge consumers hidden or at least less salient fees. In other words, a fee-driven business model incentivizes billing tricks and traps and hidden fees, which can readily veer from the merely crafty to the outright deceptive.

The price a bank charges a consumer to maintain a deposit account can readily be partitioned into several fees. For example, instead of a single annual account fee of \$100, partitioned pricing might consist of a \$6 monthly maintenance fee, a \$2 monthly paper statement fee, a \$2 monthly check-writing fee (reduced to \$1 if the consumer has direct deposit), and a \$12 annual online banking fee.

Partitioned pricing has three effects. First, it makes the total cost of a product harder for a consumer to understand—the consumer must add up all the different components of the price. This can be challenging for all consumers, not just for those with limited numeracy and mathematical skills, because some fees might be behaviorally contingent, charged only when the consumer does or does not do something. Second, partitioned pricing impedes comparison shopping by making prices non-commoditized. And third, partitioned pricing makes all the individual pricing components look smaller than a single price even if they are larger

53. *Id.* at 352.

54. 15 U.S.C. § 1693o-2 (2018).

55. 12 C.F.R. § 235.3-4 (2023). The Federal Reserve Board has proposed lowering the cap to \$0.144 plus 0.04% of the transaction value and a \$0.013 fraud prevention adjustment. Debit Card Interchange Fees and Routing, 88 Fed. Reg. 78100, 78122 (proposed Nov. 14, 2023).

56. See, e.g., Adam J. Levitin, *The Antitrust Superbowl: America's Payment Systems, No-Surcharge Rules, and the Hidden Costs of Credit*, 3 BERKELEY BUS. L.J. 265, 269 (2005).

57. *Issue 1232*, NILSON REPORT 11 (Dec. 2022) (on file with author).

in the aggregate. This is particularly true if the different price components are not all disclosed together in the same place. None of this is illegal, but it facilitates supracompetitive pricing for the entire industry.

A bank that charges a fixed, upfront fee, such as a monthly account fee, is at a competitive disadvantage to a bank that charges a contingent, back-end fee because the contingent, back-end fee is less salient to the consumer than a definite upfront fee.⁵⁸ Contingent fees will be less salient to a consumer because they are, at least in theory, avoidable, and because the consumer is unlikely to accurately estimate the frequency of their occurrence. Consumers are likely to overvalue the fixed fee relative to the contingent fee and therefore prefer the contingent fee, all else being equal.

Consider, for example, overdraft fees. Overdraft fees are a contingent fee—the fee is only charged if the consumer overdraws the account. It is difficult, however, for a consumer to accurately predict the likelihood of overdrafting, much less how many fees will actually be applied. This is because whether a consumer overdraws is dependent upon the order in which the bank posts credits and debits of various sorts to the account. Posting orders are frequently quite complicated and are ultimately set at banks' discretion, so long as banks reserve such discretion in the account terms and conditions.⁵⁹ The lack of clarity about when an overdraft fee will be charged makes such fees opaque and hard for consumers to estimate, with the result that consumers are likely to simply disregard them.

This means that a bank that does not permit or charge for overdrafts, but instead charges a fixed monthly account fee, say \$10 per month, is at a competitive disadvantage relative to a bank that charges a \$35 overdraft fee under an opaque overdraft fee policy, because the bank with the certain monthly fee will appear to be more expensive than its rival with behaviorally contingent overdraft fees, even if the fixed fee is in fact likely to be less expensive for the consumer.

The trade-off between consumer protection and financial inclusion with regard to overdraft fees is well illustrated by a New York Federal Reserve Bank staff report on the effect of a 2001 Office of the Comptroller of the Currency regulation that preempted state laws restricting overdraft fees for national banks.⁶⁰ The report found that the exempted banks increased both their overdraft fees and provision of overdraft credit.⁶¹ The exempted banks also expanded the deposit account supply by lowering

58. See Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Consumer Markets*, 121 Q.J. ECON. 505, 509 (2006). Credit cards are the classic example of this, having largely shifted away from annual fees (fixed, upfront) to late and overlimit fees (contingent, back-end).

59. See *Gutierrez v. Wells Fargo Bank, N.A.*, 704 F.3d 712, 723, 726, 729-30 (9th Cir. 2012) (upholding liability for misleading statements about transaction processing order, but overruling injunction of high-to-low posting order based on preemption principles without considering whether the bank acted in bad faith).

60. Dlugosz et al., *supra* note 17, at 3.

61. *Id.*

minimum balance requirements for deposit accounts, which corresponded with an increase in the share of low-income households with checking accounts.⁶² The report's findings suggests that there is a messy trade-off between consumer protection and financial inclusion: lower minimum balance requirements likely made it possible for more low-income households to obtain checking accounts—on which they then paid more and incurred higher overdraft fees that they could ill-afford. This episode illustrates the trilemma in action: widespread financial inclusion can be profitable to banks, but only at the expense of fairness.

Nor are such contingent “fees” on deposit accounts limited to formal fees with precise dollar amounts. They also extend to other contractual terms that shift value between consumers and banks, particularly dispute resolution terms, such as jury trial waivers, class action waivers, and binding mandatory arbitration. The right to bring or participate in a class action or to have a dispute heard publicly by a court and before a jury is potentially quite valuable, but only when a dispute arises. The availability of such legal recourse is unlikely to be assigned much value by a consumer when the consumer enters the contract because the consumer does not anticipate a dispute that is serious enough to merit litigation; consumers who anticipate such problems are likely to avoid the financial service provider. A consumer is likely to anticipate only an infinitesimally small chance of litigation and therefore will rationally discount the value of the waiver of the right to a jury, to participate in a class action, or to have a court hear their case in public.

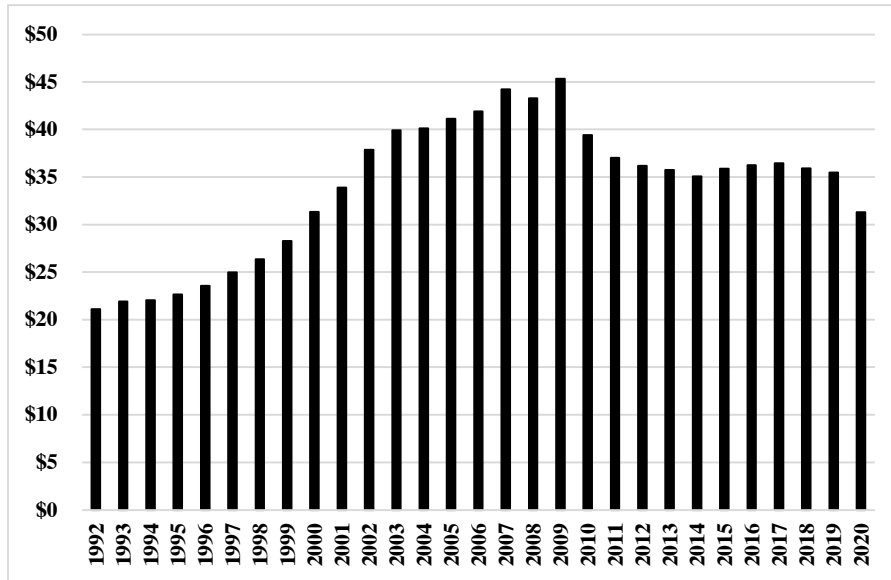
While the chance of a dispute with any individual consumer is very low, the bank is not concerned with the likelihood of a dispute with any individual consumer, but with the aggregate likelihood of a dispute, which is, by definition, greater. Accordingly, the bank will value the jury or class action waiver or arbitration clause more highly than any consumer because the possibility of a dispute with some customer is not so remote. The jury or class action waiver or arbitration clause thus has the same effect of shifting value from the consumer to the bank as a fee, but its monetary value is completely hidden. While jury and class action waivers and arbitration clauses are part of the cost of a contract, their cost is opaque and not salient to consumers who cannot take an actuarial approach to valuation because they only conduct single transactions, unlike a business that conducts multiple transactions.

Competition punishes transparent upfront pricing and pushes the entire market to opaque, back-end, behaviorally contingent pricing. Thus, virtually all deposit account agreements waive the depositor's right to a jury trial, waive the depositor's right to participate in a class action, and/or require disputes to be resolved behind closed doors through binding

62. *Id.*

mandatory arbitration.⁶³ Similarly, as Figure 3 shows, this competitive dynamic was accompanied with rapid growth in total overdraft fees charged, starting in 1992 and continuing until 2010, when regulations went into effect prohibiting the charging of fees for overdrafting on ATM and one-time (non-repeating) debit card transactions without affirmative consumer opt-in.⁶⁴

Figure 3. Total Annual Bank Overdraft Revenue (in Billions of Dollars)⁶⁵



63. *Hidden Risks: The Case for Safe and Transparent Checking Accounts*, PEW CHARITABLE TRUSTS HEALTH GRP. 18 (Apr. 2011), https://www.pewtrusts.org/~media/legacy/uploadedfiles/pcs_assets/2011/SafeCheckingPewReportHiddenRiskspdf.pdf [<https://perma.cc/P43Y-J2Y8>].

64. See Electronic Fund Transfers, 74 Fed. Reg. 59,033 (Nov. 17, 2009) (effective January 19, 2010, with a mandatory compliance date of July 1, 2010) (codified at 12 C.F.R. § 1005.17(b) (2023)). A number of smaller banks still rely on overdraft fees as the primary driver of their profitability. See Aaron Klein, *A Few Small Banks Have Become Overdraft Giants*, BROOKINGS (Mar. 1, 2021), <https://www.brookings.edu/articles/a-few-small-banks-have-become-overdraft-giants> [<https://perma.cc/G3DG-5WZA>]. A 2021 CFPB study found that banks maintain “[d]eep [d]ependence on [o]verdraft fees.” *CFPB Research Shows Banks’ Deep Dependence on Overdraft Fees*, CONSUMER FIN. PROT. BUREAU (Dec. 1, 2021), <https://www.consumerfinance.gov/about-us/newsroom/cfpb-research-shows-banks-deep-dependence-on-overdraft-fees> [<https://perma.cc/26QY-UJ8C>], but a subsequent study found that overdraft fees had fallen significantly since the pandemic, in part because of reduction and elimination of fees at some banks, *Overdraft/NSF Revenue Down Nearly 50% Versus Pre-Pandemic Levels*, CONSUMER FIN. PROT. BUREAU (May 24, 2023), <https://www.consumerfinance.gov/data-research/research-reports/data-spotlight-overdraft-nsf-revenue-in-q4-2022-down-nearly-50-versus-pre-pandemic-levels/full-report> [<https://perma.cc/BLN7-GJLK>].

65. Data procured from Moebs Services. All figures have been adjusted for inflation using the Consumer Price Index in January 2000 as the baseline. Dollars are inflation-adjusted to 2020 dollars.

The aversion to fixed, upfront fees relative to contingent, back-end fees is particularly important for small-balance deposits because a consumer with a \$100 balance will likely balk at fixed, unavoidable fees that start to approach that total balance, even if the contingent fees in total could readily be greater.

Competitive pressure creates an arms race not just for price opacity, but to actively make products look cheaper than they are. As banks try to gain competitive advantage, making their product offerings look cheaper by shifting from salient fixed fees to less salient contingent fees and contract terms, banks have an incentive to engage in behavior that further obfuscates the cost of their products, such as deceptive advertising and misleading disclosures that downplay or hide costs or simply making terms hard to access.⁶⁶ Such behavior might be unfair, deceptive, or abusive.⁶⁷ At its extreme, it means literally covering up fees.⁶⁸ A reliance on fee income incentivizes potentially problematic practices.

5. Relationship Banking

Over the past decade, another revenue model has emerged related to deposit accounts: relationship banking. In the relationship banking model, deposit accounts are not stand-alone products. Instead, they are offered as a loss-leader for other tied services, such as loans, insurance, or securities products.⁶⁹ Thus, rather than offering a stand-alone, free checking account, a checking account is now “free”—provided that the consumer obtains other services from the bank.

There are two consumer protection problems with this product tying. First, the bundled pricing is much more complicated and opaque, making it difficult for a consumer to tell if she is getting the best price on either the deposit account or the bundled product. In this regard, bundling operates as the inverse twin of partitioned pricing, an augmentation of what is included in the price instead of a diminution. For example, if the bundled product is a loan, the consumer could compare the costs of the loan to that of other loans, but that comparison would neglect the “discount” the consumer gets because of the bundled “free” checking account. The comparison is now apples to oranges.

66. See, e.g., First Amended Complaint at ¶¶ 106-118, *Consumer Fin. Prot. Bureau v. TCF Nat'l Bank*, No. 0:17-cv-001660-RHK-KMM (D. Minn. Mar. 1, 2017) (alleging abusive and deceptive sales tactics to get consumers to sign up for fee overdraft protection).

67. Recognizing this, Congress has prohibited such behavior. 12 U.S.C. § 5531 (2018).

68. See, e.g., Complaint at ¶¶ 20, 21, 67, *Consumer Fin. Prot. Bureau v. All Am. Check Cashing, Inc.*, No. 3:16-cv-00356-WHB-JCG (S.D. Miss. May 11, 2016) (alleging that defendant physically covered up the fee amount on receipts, minimized the time the consumer had to view the receipt, and interfered with the consumer's ability to see the sign listing fees).

69. *Final Nail in the Free Checking Coffin: What Can Replace Free Checking?*, MOEBS SERVS. 1 (Sept. 30, 2019), <https://moeps.com/Portals/0/pdf/Articles/Final%20Nail%20in%20the%20Free%20Checking%20Coffin.pdf> [<https://perma.cc/D4L5-922Q>].

The Financial Inclusion Trilemma

This obfuscation of pricing is precisely what banks desire because loan products in particular should be among the most commoditized products around. Given miniscule profit margins, all that the bank is selling is money, and money is completely fungible with money from other sources. Avoiding commodification helps the bank, but at the expense of the consumer.

The other problem with product tying in relationship banking is that it incentivizes the bank to constantly attempt to cross-sell the consumer on other bank products. At its extreme, this cross-selling incentive is what produced the Wells Fargo fake account scandal: Wells Fargo employees' compensation and employment depended on their ability to sell the maximum number of products to consumers. When those incentives ran into consumers' limited demand for financial products, the result was the creation of fake accounts.⁷⁰

While Wells Fargo might be the extreme case, it is hardly the only example of pressures to cross-sell resulting in deceptive practices. The Consumer Financial Protection Bureau (CFPB) entered into consent orders with U.S. Bank for similarly opening unauthorized deposit and credit card accounts.⁷¹ It has also brought suit against Fifth Third Bank for fake account creation.⁷² Likewise, the FDIC and CFPB entered into a \$214 million consent order with Discover Bank, which allegedly engaged in deceptive marketing and sales tactics to get consumers to purchase certain credit card add-on products that provided insurance-type services and credit score tracking.⁷³ The sales tactics included using misleading language depicting the products as free “benefits,” suggesting that there would be an opportunity to review printed materials before being charged, omitting key exclusions from the insurance-type product coverage, and speaking unusually fast when disclosing product prices and terms.⁷⁴ The CFPB has entered into similar consent orders with American Express⁷⁵ and Chase⁷⁶ for pushing “add-on” products onto their credit card customers. And the

70. Consent Order at ¶¶ 7-16, Wells Fargo Bank, N.A., No. 2016-CFPB-0015 (Sept. 8, 2016).

71. Consent Order at ¶¶ 24-31, Bank of Am., N.A., No. 2023-CFPB-0007 (July 11, 2023); Consent Order at ¶¶ 7-12, U.S. Bank, N.A., No. 2022-CFPB-0006 (July 28, 2022).

72. Amended Complaint at ¶¶ 4, 20-39, 53, Bureau of Consumer Fin. Prot. v. Fifth Third Bank, N.A., No. 1:21-cv-00262-DRC (S.D. Ohio June 16, 2021) (alleging that Fifth Third employees opened accounts in consumers' names without consumers' knowledge because of cross-selling pressure on employees).

73. Joint Consent Order, Order for Restitution, and Order to Pay Civil Monetary Penalty at ¶ 4-5, Discover Bank, FDIC-11-548b, FDIC-11-551k, 2012-CFPB-0005 (Sept. 24, 2012).

74. *Id.*

75. Consent Order, Am. Express Centurion Bank, No. 2013-CFPB-0011 (Dec. 24, 2013); Consent Order, Am. Express Bank, FSB, No. 2013-CFPB-0013 (Dec. 24, 2013); Consent Order, Am. Express Travel Related Servs. Inc., No. 2013-CFPB-0013 (Dec. 24, 2013).

76. Consent Order, JPMorgan Chase Bank, N.A., No. 2013-CFPB-0007 (Sept. 19, 2013).

CFPB sued TCF National Bank for deceptively pressuring its deposit customers to opt into for-fee overdraft protection.⁷⁷

Outright deceptive practices are not the only consumer protection concern in a cross-selling situation. When a bank cross-sells, it turns itself into a data platform, using data from the consumer's account to support its marketing of other products. While this might result in the consumer learning about beneficial products, it might also result in the bank targeting the consumer for products that are suboptimal for the consumer, but more profitable for the bank. The bank is in essence relying on its past relationship of trust with the consumer to sell additional products. As with a platform like Amazon, the consumer cannot opt out of such cross-selling, because there are few restrictions on the solicitation of consumers' business based on the sharing of consumers' personal data among affiliated entities.⁷⁸

6. Summary

Deposit accounts are simply not profitable on a stand-alone basis for low-balance accounts absent direct fee income or cross-selling income. Business models that depend on direct fees and cross-selling are not illegal, but prime the ground for consumer protection abuses because competitive pressure pushes banks to obfuscate costs and aggressively push other products onto the consumer. This suggests that it is not possible, on a per consumer basis, to profitably engage in widescale provision of deposit accounts to lower-income consumers without risking serious consumer protection problems. The result is that some banks offer accounts to consumers expected to have small balances, but with pricing that raises fairness concerns, while many others simply do not serve low-balance accounts. Instead, as Part III discusses, low-balance deposit accounts can only be both widely and fairly offered if subsidized, whether by taxpayers, other customers, or bank shareholders.

B. Illustration #2: The Economics of Payday Loans

The economics of payday loans provide a further illustration of the financial inclusion trilemma as applied to small-dollar credit. Payday loans—sometimes called deferred deposit advances—are a type of short-term, small-dollar loan. The terms of payday loans vary by state, depending on statutory limits on the rate, duration, and loan size, but a typical payday loan is a \$400 loan for two weeks with a \$50 fee.

77. First Amended Complaint, *supra* note 66 at ¶¶ 35-48, (alleging pressure on employees to cross-sell overdraft protection to deposit customers).

78. 15 U.S.C. § 1681s-3(a) (2018) (requiring consumers to have a right to opt out of solicitations based on consumer report data shared between affiliates).

In a traditional payday loan transaction using these numbers, the borrower would give the lender a post-dated check for \$450 in exchange for \$400 in cash. The borrower must repay the lender \$450 within two weeks or the lender will deposit the post-dated check. The loan is for \$400, and the \$50 difference between the check amount and the amount disbursed is the loan fee. There is no explicit interest rate charged on payday loans. But such a loan has an APR of 326%.⁷⁹

Consumer advocates have called for a national 36% APR usury rate,⁸⁰ arguing that loans with prices higher than 36% APR are inherently unfair to borrowers.⁸¹ The Military Lending Act of 2006 already imposes a 36% APR rate cap on certain loans made to active duty military members and their dependents.⁸² Whatever the wisdom of such a 36% APR cap, it must be recognized that it is not possible to profitably make a \$400 loan to a consumer for two weeks at a 36% APR on a stand-alone basis.

Achieving a 36% APR for a two-week loan of \$400 would require limiting fees to about \$5.50. That \$5.50 would need to cover the lender's credit losses, cost of funds, other variable per loan costs, and fixed overhead costs, as well as a profit margin. As the following sections show, some simple assumptions show that it is not possible to come anywhere close to such a cost structure.

1. Store-Front Payday Lending

Assume an independent, store-front payday lender. It might operate one or several locations. Its revenue comes solely from fees on its loans. It makes a fee every time a loan is made and again whenever the loan is rolled over (that is, refinanced with a new loan). Let's assume that the loan is subject to a 36% APR cap, so the lender cannot charge more than \$5.50 for a two-week loan of \$400. Can the lender make such a loan profitably?

Let's start with labor costs. Assume that the lender's employees make \$15 an hour, including benefits. An employee is capable of processing several loans in an hour, but actual loan production per employee is incredibly low in the payday industry because of the large number of competitors. In 2014, there were 15,766 payday lending stores in the United

79. The APR for a single payment closed-end product with a term of less than a year is calculated by taking the product of (a) 100, (b) the quotient of the days in a year (365) over the number of days of the product term (14), and (c) the difference of the quotient of the total amount required to be repaid (\$450) over the amount advanced (\$400) and one. Annual Percentage Rate Computations for Closed-End Credit Transactions, 12 C.F.R. § 1026, Appendix J(c)(5) (Form 1) (2023). Thus, here: $APR = 100 \times 365/14 \times (450/400 - 1) = 324.89\%$

80. See Veterans and Consumers Fair Credit Act, H.R. 5050, 116th Cong. (2019).

81. See, e.g., *Why Cap Interest Rates at 36%?*, NAT'L CONSUMER L. CTR. (Aug. 2021), https://www.nclc.org/wp-content/uploads/2022/09/IB_Why_36.pdf [https://perma.cc/TQ3H-85BS].

82. 10 U.S.C. § 987 (2018). The APR under the Military Lending Act is calculated using a broader definition of the finance charge than under the Truth in Lending Act. 10 U.S.C. § 987(i)(4) (2018).

States, concentrated in thirty-six states.⁸³ The average payday lending store makes between 265 and 6,327 loans per year, depending on the state,⁸⁴ with a national average of 3,541 loans per year.⁸⁵ The average payday lending store had three full-time employees.⁸⁶

Using these averages, we can see that on average it takes over 105 minutes of employee time for a payday lender to make a single loan.⁸⁷ To be clear, the actual processing takes far less, but the lender has to pay its employees regardless of whether there are customers with loans to process. At this pace, the labor costs for making a single loan are \$26.43. Recouping these costs via a \$26.43 charge on a \$400 loan for two weeks would translate to a 172% APR.⁸⁸ The labor costs alone mean that it is not possible for a payday lender to profitably lend at anything close to a 36% APR (a \$5.52 finance charge here). And this is not counting other loan-specific costs—cost of funds and credit losses—or fixed and semi-variable expenses like rent, utilities, insurance, technology systems, advertising, customer service, and legal expenses, much less sufficient profit to attract investment in the business.

Thus, although the pricing of payday loans is shockingly high, there do not generally appear to be supracompetitive profits in the payday loan industry. Barriers to entry are low: payday lending requires little capital because the loans are so small. Although there are some large, publicly-traded payday lending chains, many payday lenders are closely-held small businesses. Moreover, the state licenses required are generally a pro forma matter, in contrast to a banking charter. Therefore, even if there were supracompetitive profits, low barriers to entry mean that competition would quickly dissipate such an inefficiency. Indeed, low barriers to entry actually prevent lenders from realizing economies of scale with the effect that payday lenders cannibalize each other's businesses, driving up the

83. Payday, Vehicle Title, and Certain High-Cost Installment Loans, 81 Fed. Reg. 47864, 47871 (proposed July 22, 2016) [hereinafter Payday Rule]. In contrast, there were 14,350 McDonald's stores, spread across all fifty states that year. *Id.*

84. Montezemolo, *supra* note 32, at 26.

85. *Id.* at 26 n.2. See also *Payday Lending in America: Policy Solutions*, PEW CHARITABLE TRUSTS 18 (Oct. 2013), https://www.pewtrusts.org/~media/legacy/uploadedfiles/pes_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf [https://perma.cc/5ZCB-BEAX] (estimating fewer than 500 unique customers per store per year).

86. Payday Rule, *supra* note 83, at 47871.

87. The national average of 3,541 loans divided by 6,240 (the total employee hours product of three employees working forty hours a week each for fifty-two weeks of the year) yields approximately 0.57 loans per employee hour, which means that it takes 105.73 minutes of employee time to produce a single loan. At \$15 an hour, it takes \$26.43 to produce that single loan.

88. Although the marginal costs of making an additional loan are small, payday lenders cannot price according to marginal cost, as they charge all borrowers the same rate. Accordingly, they have to price based on average cost.

fixed costs per loan, which drives up loan pricing.⁸⁹ Payday lending presents the unusual case where greater competition *increases* prices.

Again, the point here is not the specific numbers being used, but that they illustrate the fundamental problem: even with assumptions of zero credit losses and zero profit margin, the labor costs alone of making a payday loan render it an uneconomical stand-alone product at a 36% APR. Thus, high fees are required to make payday loans a profitable product.

High fees alone are insufficient, however, for payday loan profitability. Rollovers are key to payday lender profitability. Payday lenders incur credit losses estimated to be in the range of 50% to 67% of dollars loaned.⁹⁰ Given such high credit losses, payday lending is only profitable because of rollovers and renewals. When a borrower rolls over an existing loan, the borrower does not receive an additional advance of cash, but merely retains the cash already advanced for a longer period, in exchange for paying an additional fee. Thus, while the lender's total credit exposure has not increased with a rollover, the lender has collected an additional fee.

Not surprisingly, rollovers are the profit center for payday lenders. The CFPB found that over the course of a year, 90% of all payday loan fees came from consumers who borrowed seven or more times, and 75% of fees came from consumers who borrowed ten or more times.⁹¹ This means that the payday loan product—marketed as a short-term loan product to bridge liquidity gaps—is only profitable if it is a long-term debt trap for a significant number of borrowers who face not liquidity, but solvency problems. Both the high cost and the likelihood of a long borrowing sequence raise considerable consumer protection concerns with payday loans.

2. Bank Payday Products

The economics of payday loans change when they are offered not as a stand-alone product, but as an additional product at a pre-existing business. If only the marginal costs of the payday loans are considered, not their pro-rated share of labor or overhead (which would be incurred even if they were not offered), then payday loans can be “profitably” offered at lower prices. Indeed, this is the conceit behind proposals for the United States Postal Service to offer payday loans.⁹²

89. *See Trial, Error, and Success in Colorado's Payday Lending Reforms*, PEW CHARITABLE TRUSTS 5-7 (Dec. 2014), https://www.pewtrusts.org/~media/assets/2014/12/pew_co_payday_law_comparison_dec2014.pdf [<https://perma.cc/CYN9-PUL2>] (finding that Colorado's 2010 payday loan law reform resulted in the number of lenders falling by approximately 50%, but because loan volume remained steady, per store borrowers roughly doubled and loan prices fell).

90. Payday Rule, *supra* note 83, at 47874.

91. *Id.*

92. *See supra* note 19.

Likewise, some banks and credit unions have been offering payday-loan-type products to existing consumers.⁹³ These bank and credit union payday products have a lower cost than independent payday loan products. It is unclear if these institutions are able to offer their payday-type products profitably on a stand-alone basis, or if they are cross-subsidizing from other products or consumers. It seems unlikely, however, that these products are able to generate enough revenue to cover their pro-rated share of labor and overhead. At best, the revenue generated covers the products' marginal costs.

Additionally, the banks and credit unions are likely able to offer these products at lower cost because they benefit both from pre-existing coverage of overhead costs and from a cream-skimming effect: their borrowers are not typical payday borrowers, but are pre-existing (and long-standing) depositors who pose less credit risk than the typical payday borrower. Not only are the borrowers themselves unrepresentative of the general population of payday borrowers, but by virtue of the pre-existing relationship, the bank or credit union also has substantially more information about the borrower and the ability to offset funds the moment they come into the borrower's account, beating out all competing creditors for the funds. In contrast, a regular payday lender has to guess when there will be funds in a customer's bank account and compete with other creditors to grab those funds. Moreover, the borrower with a pre-existing banking relationship with the lender feels a greater relational pressure to repay the loan, lest a default endanger the borrower's deposit account relationship (and perhaps other product relationships with the bank or credit union).

3. Online Payday Lending

Online lending holds out the promise of a reduced cost structure, particularly by way of reduced overhead. Yet online payday loans are not cheaper than store-front products. In fact, they tend to be more expensive. Part of this is a function of the adverse selection problem faced by online lenders, which are likely to attract borrowers nationwide who are unable to obtain local storefront credit.⁹⁴ But the cost of online loans is also a function of online lenders' much higher costs of customer acquisition.

93. See Ann Carrns, *An Alternative to Payday Loans, but It's Still High Cost*, N.Y. TIMES (Sept. 21, 2018), <https://www.nytimes.com/2018/09/21/your-money/alternative-payday-loans-high-interest-us-bank.html> [<https://perma.cc/9KLH-9LP9>] (describing U.S. Bank's "Simple Loan" product, which loans between \$100 and \$1,000 at a cost of twelve dollars for each \$100 borrowed); 12 C.F.R. § 701.21(c)(7)(iii)-(iv) (2023) (regulating payday alternative loans).

94. Online lenders have higher default rates than storefront payday lenders. Payday Rule, *supra* note 83, at 47990 (noting a 41% default rate for online loans, compared to a 17% default rate for storefront loans, 55% sequence default rate for online loans (an eventual default in a sequence of rolled-over loans by the same borrower), and a 34% sequence default rate for storefront loans).

Storefront lenders generally rely on foot traffic to generate business. For that reason, they are frequently situated at busy intersections.⁹⁵ Online lenders are not able to attract customers through their physical location. While some lenders make loans to consumers who access their websites directly, most obtain customers through lead generators. As many as 75% of online payday loans are originated through lead generators.⁹⁶

Payday loan lead generators enable otherwise competing small lenders to pool advertising resources. A lead generator advertises for potential borrowers, but does not make loans itself.⁹⁷ Instead, the lead generator collects payday loan applications from borrowers and auctions the “lead” and associated loan application off in real time to prospective lenders. The winning bidder gets the right to contact the borrower using the information in the loan application. If the winning lender cannot close the deal, the lead is reauctioned as a “second look” at a lower price.

The lead generator system helps online lenders avoid a common pool collective action problem in advertising. To beat out other lenders for customers, an online lender will generally have to out-spend its competitors for advertising. The result is an arms race in advertising because online lenders have to spend more and more to have their ads be the ones consumers see—the top search hit, for example. The result of such an advertising arms race would be to reduce all lenders’ profit margins by increasing everyone’s costs without necessarily expanding the pool of potential borrowers.

The lead generator system has the effect of pooling advertising. The lead generator does the advertising, rather than the lenders, and the pooled resources enable better advertising than any individual lender could afford. The pooling benefit comes at a cost, however. Because of the competitive auction system, online lenders must pay a substantial amount to win each lead. A high quality, first look lead runs in the range of \$150 to \$200.⁹⁸

There is no guarantee, however that the lender will even be able to close the loan; the lead is only a right to deal with the borrower. Many leads purchased do not result in a loan, so online lenders have to purchase several leads to make one loan. The costs of the lead acquisition plus credit losses, operation costs, cost of funds, and any profit must be recouped from only those leads that result in loans.

95. Sheila R. Foster, *Breaking Up Payday: Anti-agglomeration Zoning and Consumer Welfare*, 75 OHIO ST. L.J. 57, 62 (2014).

96. Andrew R. Johnson, *Middlemen for Payday Lenders Under Fire*, WALL ST. J. (Apr. 7, 2014, 9:50 PM), <https://www.wsj.com/articles/SB10001424052702304819004579487983000120324> [<https://perma.cc/NB8H-6F98>].

97. *Led Astray: Online Lead Generation and Payday Loans*, UPTURN 1 (Oct. 2015), https://www.upturn.org/static/reports/2015/led-astray/files/Upturn_-_Led_Astray_v.1.01.pdf [<https://perma.cc/D4QE-QYQZ>].

98. Payday Rule, *supra* note 83, at 47878.

To illustrate, if an online lender spends \$50 to acquire a lead, and only one in five leads results in a loan, it will cost the lender \$250 to acquire one actual customer. If that customer is charged \$50 on a \$400 loan, the lender cannot even recoup its cost of customer acquisition without four rollovers, much less its other expenses and profit margin. The high cost of leads ensures that online lenders must charge high fees and roll over loans. It is not possible to profitably engage in online payday lending otherwise.

The illustrations of both deposit account economics and payday loan economics point to the same problem with small-balance deposits and small-dollar lending: the small size of the transaction means that it is not possible to profitably offer these products as stand-alone products on a wide scale and at fair terms. Only two of the three goals—profitability, scale, and fairness—can be simultaneously achieved.

III. The Financial Inclusion Policy Playbook

The previous Part examined why the financial inclusion trilemma exists. This Part turns to the policy playbook for addressing financial inclusion. It reviews the different policy options and how they have been used or ignored in the United States: private provision, including technological advances; soft mandates; hard mandates (cross-subsidies); public options; and public subsidies.

A. Existing Approaches to Financial Inclusion

1. Private Provision: Fintech, Crypto, and Deregulation

In the United States, private provision of financial services has long been the primary means of pursuing financial inclusion. It has not worked. As the previous Part has shown, the economics of small deposits and small-dollar loans require fee-based income or extremely high interest rates, both of which are problematic from a consumer protection standpoint. Private provision will occur only if provision is profitable, so if policy makers rely on private provision, the choice becomes one of access versus fairness.

The result has been different in the deposit and credit contexts. In the deposit context, deposit accounts for low-income consumers are not widely available. To the extent accounts are available, banks cover their costs with overdraft and other account fees. In the credit context, loans are widely available, but at extremely high costs. In recent years, however, a tightening of consumer credit regulation in a number of states⁹⁹ has

99. ARK. CONST. amend. LXXXIX, § 3 (establishing a 17% usury cap in the Arkansas state constitution); 2019 Cal. Stat. ch. 708 (establishing a 36% usury cap over the Federal Funds rate in California); COLO. REV. STAT. § 5-3.1-105 (2020) (establishing a 36% APR cap for payday

resulted in lower availability of credit or substitution to other forms of less-regulated credit, such as pawn, rent-to-own, and borrowing from family and friends.¹⁰⁰

i. Fintech

Fintech—a portmanteau of “financial technology”—is the newest guise of private provision of financial services. Fintech refers to “technology-enabled innovation in financial services that could result in new business models, applications, processes or products with an associated material effect on the provision of financial services.”¹⁰¹ Fintech companies, or “fintechs,” are nonbank financial service companies that rely on technologies, such as “web-or mobile-based consumer interfaces, automated underwriting, neural network and other machine-learning-based underwriting, and the use of nontraditional underwriting data sources to provide financial services to consumers.”¹⁰² A more recent twist on fintechs has been the use of cryptocurrency and decentralized finance.

Fintech has always held out the promise of being the silver bullet for financial inclusion,¹⁰³ although much of that promise is directed at the developing world rather than the United States.¹⁰⁴ The argument presented by fintechs is that they (1) are better able to connect with underserved populations because of their online presence and (2) can lower the cost of

loans in Colorado); 815 ILL. COMP. STAT. 123 / 15-5-5 (2021) (establishing a 36% military APR usury cap in Illinois); HAW. REV. STAT. § 480J-4 (establishing 36% usury cap in Hawaii); MONT. CODE ANN. § 31-1-701 (2010) (establishing a 36% usury cap in Montana); NEB. REV. STAT. § 45-918 (2020) (establishing a 36% rate cap in Nebraska); OHIO REV. CODE ANN. § 1321.40 (establishing 28% usury cap in Ohio); S.D. CODIFIED LAWS § 54-4-36 (2016) (establishing 36% interest rate cap on consumer loans in South Dakota); 2020 Va. Acts ch. 1258 (establishing 36% APR cap in Virginia).

100. Angela Littwin, *Testing the Substitution Hypothesis: Would Credit Card Regulations Force Low-Income Borrowers Into Less Desirable Lending Alternatives?*, 2009 U. ILL. L. REV. 403, 405 (2009) (finding evidence that restrictions on credit result in either lower consumption or a shift to borrowing from family and friends).

101. *Financial Stability Implications from Fintech: Supervisory and Regulatory Issues that Merit Authorities’ Attention*, FIN. STABILITY BD. 7 (June 27, 2017), <https://www.fsb.org/wp-content/uploads/R270617.pdf> [<https://perma.cc/CG6L-6CCU>]. See also *Examining Opportunities and Challenges in the Financial Technology (“Fintech”) Marketplace: Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Servs.*, 115th Cong. 86 (2018) (statement of Professor Adam J. Levitin) (discussing definitional problems regarding “fintechs” and noting that fintechs are distinguished by being nonbank financial services companies that use various forms of digital technology to provide financial services to consumers).

102. *Examining Opportunities and Challenges in the Financial Technology (“Fintech”) Marketplace*, *supra* note 101, at 87.

103. See, e.g., *id.* at 5; Kalin Anev Janse & Gong Cheng, *Can Fintech Make the World More Inclusive?*, KNOWLEDGE AT WHARTON (Oct. 10, 2019), <https://knowledge.wharton.upenn.edu/article/can-fintech-make-the-world-more-inclusive> [<https://perma.cc/M5JN-HDYA>]; Rupert Shaw, *Why Fintech is the Biggest Driver of Financial Inclusion*, FINTECH MAG. (Apr. 30, 2021), <https://fintechmagazine.com/financial-services-finserv/why-fintech-biggest-driver-financial-inclusion> [<https://perma.cc/AUB9-AVEJ>].

104. Microfinance programs abroad are simply not transferrable to the U.S. situation. The dollar scale involved is different, and microfinance abroad is business finance, enabling productivity. U.S. financial inclusion is not about small business, but about living expenses.

providing financial services because they lack the legacy cost structure of traditional brick-and-mortar financial institutions. The idea is that technological developments—particularly the widespread dissemination of smart phones, the development of blockchain-based applications, and the increased use of big data, alternative data sources, and artificial intelligence—will enable cheaper customer identification verification, cheaper and faster payments, and underwriting that serves more consumers more cheaply.¹⁰⁵ Furthermore, because fintechs lack brick-and-mortar operations, their advent holds out the promise of eliminating discrimination based on physical observation of consumer characteristics.¹⁰⁶

Fintech companies have leveraged this vague promise of future financial inclusion benefits to obtain immediate regulatory relief through “sandboxes”¹⁰⁷—effectively regulatory exemptions—that give them a competitive advantage over their non-exempt traditional institution rivals. Fintech, however, has yet to deliver on its promise in the United States. Fintech is about a decade old now, but it has not produced material results in terms of financial inclusion.

To be sure, certain payment fintechs have been quite successful—PayPal and Venmo, for example—but they have not moved the needle on financial inclusion. Instead, they have primarily poached business from traditional banks. As noted above, a PayPal or Venmo account, for example, can be used much like a bank account as a store of value, but it can only be used to make payments at a limited number of merchants and requires funding to come either from a bank account, a credit card (which generally requires a bank account), or other PayPal or Venmo accounts. In

105. It should be noted that technological solutions can actually *reduce* financial inclusion, particularly for the elderly. Technological solutions frequently require consumers to keep track of passwords, which can be a challenge for those with memory issues associated with senescence. Likewise, navigating apps and websites can be a challenge for digital non-natives.

106. Thomas Philippon, *On Fintech and Financial Inclusion* 10-11 (Bank for Int'l Settlements, Working Paper No. 841, 2020). While this appears to have been borne out in the first generation of fintech (predating the term), namely the automated underwriting programs used by Fannie Mae and Freddie Mac, LEVITIN & WACHTER, *supra* note 42, at 85-86, there are also risks of bias in algorithmic underwriting or in machine learning. *See, e.g.*, Robert Bartlett, Adair Morse, Richard Stanton & Nancy Wallace, *Consumer-Lending Discrimination in the FinTech Era*, 143 J. FIN. ECON. 30 (2022); CATHY O'NEIL, *WEAPONS OF MATH DESTRUCTION: HOW BIG DATA INCREASES INEQUALITY AND THREATENS DEMOCRACY* (2016); FRANK PASQUALE, *THE BLACK BOX SOCIETY: THE SECRET ALGORITHMS THAT CONTROL MONEY AND INFORMATION* 35, 38-42 (2016).

107. CONSUMER FIN. PROT. BUREAU, CFPB-2018-0042, POLICY ON NO-ACTION LETTERS (2018); CONSUMER FIN. PROT. BUREAU, CFPB-2018-0042, POLICY ON THE COMPLIANCE ASSISTANCE SANDBOX (2018); CONSUMER FIN. PROT. BUREAU, CFPB-2018-0023, POLICY TO ENCOURAGE TRIAL DISCLOSURE PROGRAMS (2018). Several states have also authorized regulatory sandboxes. *See, e.g.*, ARIZ. REV. STAT. ANN. §§ 41-5601 (2023) (authorizing a fintech regulatory sandbox in Arizona); 2019 Ky. Acts. ch. 147 (authorizing a regulatory sandbox in Kentucky); UTAH CODE ANN. §§ 13-55-101 (LexisNexis 2023) (authorizing a regulatory sandbox in Utah); W. VA. CODE R. § 31A-8G-1 (2023) (authorizing a regulatory sandbox in West Virginia); 2019 Wyo. Sess. Laws ch. 61 (authorizing a regulatory sandbox in Wyoming); VT. STAT. ANN. tit. 8, § 15a (2023) (authorizing a regulatory sandbox in Vermont).

other words, PayPal and Venmo are not banking the unbanked so much as providing an alternative transaction platform for consumers who are already banked.

The uncomfortable truth about fintech is that it is unlikely to ever be transformative with regard to financial inclusion in developed economies. Whatever marginal efficiencies fintechs might realize are simply insufficient to overcome the fundamental economic problems of small-balance deposit accounts or small-dollar lending.

When fintechs are able to reach new customers, the economics of small transactions often force problematic practices. Some of the leading fintech lenders—Think Finance (ranked second in 2013 on *Forbes*' list of "America's Most Promising Companies"),¹⁰⁸ Elevate Financial, and OppLoans—have business models that depend on evasion of state usury laws, resulting in them being sued by regulators for consumer protection violations.¹⁰⁹

Indeed, it would be strange to think that fintech could successfully address the financial inclusion problem in credit. Credit fintechs are built upon economies of scale. The problem, however, is that economies of scale work only when consumer relationships work predictably and are simple. They aren't. The *Anna Karenina* Rule of consumer law is that every unhappy consumer is unhappy in his or her own way.¹¹⁰ Because of the unique nature of unhappy consumers, attempting to deal with them in a cookie cutter fashion will inevitably produce poor results. This has been shown repeatedly with problems in mortgage loan and student loan servicing.¹¹¹ Low-income consumers, in particular, are likely to present an *Anna Karenina* problem because of the volatility of their financial lives.

108. J.J. Colao, *America's Most Promising Companies: The Top 25*, FORBES (Feb. 6, 2013, 10:00 AM), <https://www.forbes.com/sites/jjcolao/2013/02/06/americas-most-promising-companies-the-top-25> [https://perma.cc/N4L7-G8ZM].

109. See, e.g., Complaint, District of Columbia v. Elevate Credit, Inc., No. 2020-CA-002697 (D.C. Super. Ct. June 5, 2020) (alleging violations of DC's usury, lender licensing, and consumer protection laws); Cross-Complaint, Opportunity Financial, LLC v. Hewlett, No. 22STCV08163 (Cal. Super. Ct. Sept. 30, 2022) (alleging violations of California's usury and licensing laws); Complaint, Pennsylvania v. Think Fin., Inc., No. 2-14-cv-07139-JCJ (E.D. Pa. Jan. 26, 2018) (alleging violations of Pennsylvania's usury law); Complaint, Consumer Fin. Prot. Bureau v. Think Fin., LLC, No. 17-cv-00127-BMM (D. Mont. Nov. 15, 2017) (alleging violations of federal unfair, deceptive, or abusive acts or practices statute based on underlying violations of state usury law); Second Amended Complaint, Zavislan v. Avant of Colo. LLC, No. 2017CV30377 (Colo. Dist. Ct. Nov. 30, 2018) (alleging violation of Colorado's usury and licensing laws); Second Amended Complaint, Fulford v. Marlette Funding, LLC, No. 2017CV30376, 2019 WL 4451038 (Colo. Dist. Ct. June 5, 2019) (alleging violation of Colorado's usury and licensing laws).

110. LEO TOLSTOY, ANNA KARENINA 1 (Richard Pevear & Larissa Volokhonsky trans., Penguin Classics 2004) ("Happy families are all alike; every unhappy family is unhappy in its own way.").

111. Complaint at ¶ 4, Consumer Fin. Prot. Bureau v. Navient Corp., No. 3:17-cv-00101-RDM (M.D. Pa. Aug. 4, 2017) (alleging rampant misservicing of student loans); Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REGUL. 1 (2011) (detailing misservicing of mortgage loans).

ii. Cryptocurrencies

The latest supposed technological panacea for financial inclusion is cryptocurrencies and decentralized finance (DeFi). Some promoters of cryptocurrency have argued that it can substantially increase financial inclusion.¹¹² While the underbanked appear to be overrepresented among cryptocurrency users,¹¹³ there is little evidence to date that cryptocurrencies have materially improved financial inclusion.¹¹⁴

Cryptocurrencies are a poor store of value, undercutting cryptocurrency platforms' value as an ersatz banking system. Cryptocurrencies have extremely volatile prices,¹¹⁵ making it possible for investments in cryptocurrency to rapidly lose a substantial part of their value. Consumers, particularly those with more limited wealth, are generally ill-suited for handling financial volatility, as they lack the ability to adequately hedge and diversify their exposures.¹¹⁶ Additionally, the bankruptcies of a number of leading cryptocurrency platforms have saddled consumers who custodied their cryptocurrency with those platforms with illiquidity at best and significant losses at worst.

Cryptocurrency is also an inefficient payment mechanism. Payments in cryptocurrency are likely more expensive than fiat payments, particularly when costs of converting from and to fiat currency are included. For example, by one estimate, the cost to send \$200 via Tether, a popular stablecoin, from a U.S.-dollar-denominated bank account to a Euro-denominated account using some of the most popular cryptocurrency exchanges would be between \$5.98 and \$86.44.¹¹⁷ In contrast, sending \$200 via Western Union would cost \$4.88.¹¹⁸

112. Michael Hsu, Acting Comptroller of the Currency, Off. of the Comptroller of the Currency, Remarks Before the Blockchain Ass'n: Cryptocurrencies, Decentralized Finance, and Key Lessons from the 2008 Financial Crisis, 1, 3, 7 (Sept. 21, 2021); Tonantzin Carmona, *Debunking the Narratives About Cryptocurrency and Financial Inclusion*, BROOKINGS (Oct. 26, 2022), <https://www.brookings.edu/articles/debunking-the-narratives-about-cryptocurrency-and-financial-inclusion/> [https://perma.cc/AF9H-A85B].

113. Michael J. Hsu, Acting Comptroller of the Currency, Off. of the Comptroller of the Currency, Remarks Before the Inst. of Int'l Econ. L. at Geo. Univ. L. Ctr.: Thoughts on the Architecture of Stablecoins 1 (Apr. 8, 2022).

114. Alex Fredman & Todd Phillips, *Claims That Crypto Bolsters Financial Inclusion Are Dubious*, CTR. FOR AM. PROGRESS (Mar. 25, 2022), <https://www.americanprogress.org/article/claims-that-crypto-bolsters-financial-inclusion-are-dubious> [https://perma.cc/2GYA-Z7FJ] (explaining why it is unlikely that cryptocurrencies contribute to financial inclusion); Hsu, *supra* note 112, at 7-8 (questioning how cryptocurrencies expand access to banking and credit).

115. Carmona, *supra* note 112.

116. Stablecoins, a subset of cryptocurrencies, have values that are supposed to be pegged to the value of a fiat currency, but they can lose their peg, and even when they do not, they are primarily used for transactions between cryptocurrencies rather than for purchases of other goods and services. *Id.*

117. *Stablecoins: How Do They Work, How Are They Used, and What Are Their Risks?: Hearing Before the S. Comm. on Banking, Hous., & Urb. Affs.*, 117th Cong. 10 (2021) (written testimony of Alexis Goldstein, Director of Fin. Pol'y, Open Mkts. Inst.).

118. *Id.*

The Financial Inclusion Trilemma

Additionally, clearing speeds for cryptocurrency payments are unpredictable, depending on network demand and transaction fees. Unpredictable clearing times, combined with the lack of a bank guaranty of payment, makes cryptocurrency impractical as a payment system for spot commercial transactions. For example, a bicycle shop will not let a customer ride off with a new bike based on a cryptocurrency payment that has not yet cleared, because if the payment does not clear, the bicycle shop with all difficulty ever collecting from the customer. Likewise, the economics of contract enforcement for small-dollar contracts makes cryptocurrency impractical for forward transactions, especially if over the Internet: a merchant that delivers goods before a cryptocurrency transaction clears risks never getting paid, while a consumer who pays before a merchant delivers risks that the goods will never be delivered. Credit cards and electronic fund transfers (including debit cards) solve these problems with a bank guaranty of payment that ensures that the merchant and the consumer can engage in the transaction because they are assuming the payment risk not of a stranger, but of a highly regulated financial institution that is subject to various statutory requirements regarding non-judicial error resolution processes.¹¹⁹ With a credit card, (but not for an electronic fund transfer) if the merchant does not deliver the goods promised, the consumer can have the transaction reversed as a “billing error,”¹²⁰ and with a credit card or an electronic fund transfer, if the consumer lacks sufficient funds to pay for the purchase or simply absconds, that is the bank’s problem, not the merchant’s, as the bank has undertaken to pay the merchant when it authorizes the transaction. The uncertainty of clear speed plus the lack of a bank guaranty means that cryptocurrencies are not workable as a commercial medium.¹²¹

The false messiah of technology has enabled policy makers to avoid grappling with the uncomfortable realities of financial inclusion, namely that private provision alone is insufficient. Financial inclusion is not achievable without strong governmental interventions. At the same time, fintech firms have exploited the promise of financial technology as a deregulatory strategy that gives them a competitive leg up on traditional rivals. Not surprisingly, those traditional rivals have responded by calling for a level playing field, but the level playing field they seek is one that is deregulated for all. In other words, traditional financial institutions use

119. 15 U.S.C. § 1666 (2018) (providing statutory error resolution requirements for credit cards); 12 C.F.R. § 1026.13 (2023) (providing regulatory error resolution requirements for credit cards); 15 U.S.C. § 1693f (2018) providing statutory error resolution requirements for electronic fund transfers); 12 C.F.R. § 1005.11 (2023) (providing regulatory procedures for resolving error resolution requirements for electronic fund transfers).

120. 15 U.S.C. § 1666(b)(3) (2018); 12 C.F.R. § 1026.13(a)(3) (2023).

121. Layer Two applications, like the Lightning Network, may improve the commercial usability of cryptocurrency, but often at the expense of other problems.

fintechs as the camel's nose under the regulatory tent. Financial inclusion has become a beard for deregulation.

2. Negative Service Mandates

The United States has long buttressed private provision with negative mandates, specifically prohibitions on discrimination against certain protected classes. The Equal Credit Opportunity Act of 1974 (ECOA) prohibits discrimination in credit transactions on the basis of race, color, religion, national origin, sex or marital status, age, or income derived from public assistance.¹²² ECOA, however, only extends to credit transactions. It does not cover the opening of deposit accounts. There is no federal anti-discrimination law that addresses the situation of the unbanked.¹²³

ECOA covers the underbanked, at least for credit transactions, but it does not help when a consumer cannot obtain credit from a bank because of poor credit quality. At most, ECOA lets the consumer know why her loan application was rejected.¹²⁴ While that is helpful in policing discrimination against protected classes, it is not generally relevant for ensuring the provision of fairly priced small-dollar credit. Indeed, the problem with short-term, small-dollar credit is that the terms are onerous for all borrowers, irrespective of membership in a protected class. If anything, the concern with predatory lending is “reverse redlining,” in which minority communities are targeted for offers of high-cost credit, rather than being denied credit. Once again, the trilemma holds: negative service mandates help protect equality of access, but as with fintech, then force a choice between fairness of terms and profitability. Negative mandates do little work for financial inclusion.

3. Soft Service Mandates

In addition to public provision and a negative anti-discrimination mandate, the United States also has a soft mandate for financial inclusion. The Community Reinvestment Act of 1977 (CRA) requires bank regulators to evaluate whether each bank is “meeting the credit needs of its entire community, including low- and moderate-income neighborhoods.”¹²⁵ The regulatory implementation of the CRA imposes

122. 15 U.S.C. § 1691(a) (2018).

123. *CFPB Targets Unfair Discrimination in Consumer Finance*, CONSUMER FIN. PROT. BUREAU (Mar. 16, 2022), <https://www.consumerfinance.gov/about-us/newsroom/cfpb-targets-unfair-discrimination-in-consumer-finance> [<https://perma.cc/YVR7-4C4P>] (noting that the CFPB will treat discrimination in financial services other than credit as violating the prohibition on “unfair” acts or practices). A federal court has enjoined the CFPB’s amendment of its Supervision and Examination Manual that implemented this policy. *Chamber of Commerce v. Consumer Fin. Prot. Bureau*, No. 6:22-cv-00381-JCB (E.D. Tex. Sept. 8, 2023) (order granting preliminary injunction).

124. 15 U.S.C. § 1691(d)(2) (2018).

125. 12 U.S.C. § 2906(a)(1) (2018).

different types of tests depending on the size of the bank and whether it is a retail, wholesale, or limited purpose bank. Since 1995, however, the largest retail banks—those with over \$1.322 billion (as of 2023) in assets—have been evaluated using three tests: a lending test, an investment test, and a service test.¹²⁶

The lending test looks at the number, amount, and geographic distribution of loans.¹²⁷ The analysis focuses on geographic area, not on actual borrowers.¹²⁸ Thus, if a bank is lending to yuppies in a gentrifying (but still low-to-moderate income) neighborhood, it could readily get CRA credit for it.

The investment test is focused on the amount of qualified community development investments made by the bank, such as investments related to affordable housing, community services targeted to low- to moderate-income individuals, small business investment, and neighborhood revitalization or stabilization projects.¹²⁹

The service test is an imprecise standard that looks primarily at the geographic distribution of bank branches, but not at the actual number or volume of deposits.¹³⁰ Thus, while the CRA provides a general nudge for banks to provide services to low- to moderate-income communities, it does not actually ensure provision of services to low- to moderate-income individuals.

Each test is scored with one of five grades, and each grade is assigned a specified number of points. The points, however, are not the same for each test. Whereas there are up to twelve points available under the lending test, there are only six points available under both the investment and service tests.¹³¹ This scoring system means that provision of deposit accounts—which, along with a number of other services, would fall under the service test—is treated as much less important than lending—which falls under the lending test. And even for lending, the emphasis is on large-dollar loans, such as mortgage loans.

Perhaps more importantly, the CRA lacks teeth. A bank's CRA compliance rating is publicly disclosed,¹³² and the bank's CRA compliance record is one of many factors taken into account when bank regulators evaluate whether to approve the bank's acquisition of another bank,

126. 12 C.F.R. § 25.12(u), 25.21(a) (2023).

127. 12 C.F.R. § 25.22(b) (2023).

128. 12 C.F.R. §§ 25.22(a)(1), 25.41 (2023).

129. 12 C.F.R. § 25.23 (2023).

130. Michael A. Stegman, Kelly Thompson Cochran & Robert Faris, *Toward a More Performance-Driven Service Test: Strengthening Basic Banking Services Under the Community Reinvestment Act*, 9 GEO. J. ON POVERTY L. & POL'Y 405, 414-16 (2002) (discussing elements of the service test).

131. Community Reinvestment Act Regulations, 60 Fed. Reg. 22156, 22170 (May 4, 1995). The point system is only in the preamble of the final rule; it is not in the codified regulation.

132. 12 U.S.C. § 2906(b)(1)(A)(iii) (2018).

mergers, or branch applications.¹³³ Beyond such publicity and a possible impact on mergers, however, there are no legal consequences for a bank that does not meet community credit needs. The main impact of the CRA as currently implemented is to discourage redlining in mortgage lending; there is no evidence suggesting that it has accomplished much in terms of reducing the unbanked population or expanding small-dollar credit. As with negative service mandates, soft service mandates help ensure products are widespread, but do not resolve the fairness-versus-profitability tension.

4. Modeling Pilot Programs

The federal government has also attempted to expand financial inclusion using pilot programs to test and model concepts. This has generally involved relatively small-scale grants and experiments, none of which have produced notable results. In 2000, for example, the Clinton Administration announced the “First Accounts” initiative to “bring the ‘unbanked’ into the mainstream.”¹³⁴ The initiative consisted of a \$30 million dollar set of grants for community groups to work with financial institutions in expanding bank account services to low-income consumers.¹³⁵ The initiative also encouraged banks to experiment with placing no-fee ATMs in post office branches.¹³⁶ The initiative does not seem to have had much result.

In 2008, the FDIC engaged in a two-year pilot program to see if banks could profitably offer small-dollar loans as an alternative to payday loans.¹³⁷ The pilot loans were for no more than \$2,500 at APRs of 36% or less and for terms of at least ninety days.¹³⁸ While the FDIC touted the program as a success, its report noted that most of the pilot program participants saw the small-dollar loans as a tool for building or retaining otherwise profitable relationships with consumers, for creating community goodwill, or for garnering CRA benefits; few saw them as profitable on their own.¹³⁹ The report noted that because of the loans’ small size, the interest and fees generated are not always sufficient to achieve robust

133. 12 C.F.R. § 25.21, 25.29 (2023).

134. *President Clinton Unveils “First Accounts”: Bringing the “Unbanked” into the Financial Mainstream*, WHITE HOUSE OFF. OF THE PRESS SEC’Y (Jan. 13, 2000), https://clintonwhitehouse3.archives.gov/WH/New/html/20000113_2.html [<https://perma.cc/5L85-89BA>].

135. *Id.*

136. *Id.*; Larry Rulison, *Baltimore Gets ‘Free’ ATMs for Area’s Needy*, BALT. BUS. J. (Jan. 24, 2000, 12:00 AM), <https://www.bizjournals.com/baltimore/stories/2000/01/24/story6.html> [<https://perma.cc/CB47-NGFG>].

137. *FDIC’s Small-Dollar Loan Pilot Shows Banks Can Offer Alternatives to High-Cost, Short-Term Credit; Results in Safe, Affordable and Feasible Template for Small-Dollar Loans*, FED. DEPOSIT INS. CORP. (June 24, 2010), <https://archive.fdic.gov/view/fdic/4021> [<https://perma.cc/T6EQ-PHXE>].

138. *A Template for Success: The FDIC’s Small-Dollar Loan Pilot Program*, 4, FDIC Q., 28, 28 (2010).

139. *Id.* at 32.

short-term profitability. Rather, most pilot bankers sought to generate long-term profitability through volume and by using small-dollar loans to cross-sell additional products.¹⁴⁰

In other words, it does not appear that the FDIC pilot program's small-dollar loans were profitable on a stand-alone basis at a 36% APR. Instead, they primarily worked as relationship-building (i.e., loss leader) products. Not surprisingly, few banks offer such products.¹⁴¹

In 2011, the FDIC ran a pilot program at nine banks using its Model Safe Accounts Template for low-fee deposit accounts.¹⁴² Under the pilot program, 662 transaction accounts and 2,883 savings accounts were opened.¹⁴³ Over a year, 19% of the transaction accounts and 5% of the savings accounts were closed,¹⁴⁴ suggesting lower credit risk than anticipated.¹⁴⁵ The FDIC observed several business models emerging in the program, including using the Safe Accounts as “second chance” accounts for consumers with credit problems, but also a “Cross-Selling Model” that used the offer of one type of low-fee account to offer another type of additional account.¹⁴⁶

The FDIC's standards provided the starting point for arguably the most successful attempt to date at providing low-fee bank accounts to the unbanked. In 2015, the nonprofit organization Cities for Financial Empowerment Fund launched a project called “Bank On” to coordinate a national standard for low-cost checking accounts.¹⁴⁷ The Bank On standards were based on those of the FDIC's Model Safe Accounts Template. The initial results are encouraging; as of 2022, some 17.4 million accounts had been opened.¹⁴⁸ Over a quarter of accounts are closed every year, however, so as of 2022, only 8.1 million of those accounts remained

140. *Id.*

141. *See id.* at 34 (“Banks other than those in the [FDIC] pilot provide small-dollar loans, but it is likely that most banks do *not* offer these loans.”). Based in part on the FDIC's pilot program, the National Credit Union Administration (NCUA) authorized federal credit unions to make “payday loan alternatives” with a 28% APR rate cap plus an application fee of up to \$20, but only to existing credit union members. Final Rule, *Short-Term, Small Amount Loans*, 75 Fed. Reg. 58285 (Sept. 24, 2010). In response to the modest uptake by credit unions, NCUA expanded the allowed terms, enabling new members to immediately obtain the loans. Payday Alternative Loans, 84 Fed. Reg. 51942, 51943 (Oct. 1, 2019) (codified at 12 C.F.R. § 701.21 (2023)). It is unclear how much take-up there has been since.

142. *FDIC Model Safe Accounts Pilot: Final Report*, FED. DEPOSIT INS. CORP. 1 (Apr. 2012), <https://www.fdic.gov/consumers/template/SafeAccountsFinalReport.pdf> [<https://perma.cc/AK3J-DK4A>].

143. *Id.* at 6-7.

144. *Id.*

145. *Id.* at 8.

146. *Id.*

147. *Bank On Coalition Playbook: Equipping Bank On Coalitions for Local Banking Access Success*, BANK ON 5, 7 (July 2022), https://issuu.com/cfefund/docs/bank_on_playbook_jan_2017 (on file with author).

148. Violeta Gutkowski & Lisa J. Locke, *The Bank On National Data Hub: Findings from 2022*, FED. RSRV. BANK OF ST. LOUIS (Nov. 8, 2023), <https://www.stlouisfed.org/community-development/bank-on-national-data-hub/bank-on-report-2022> [<https://perma.cc/WZM8-HSPB>].

open.¹⁴⁹ Three-fourths of the accounts were opened at large financial institutions, rather than at community banks,¹⁵⁰ and 98% of the accounts open as of the end of 2022 were at large financial institutions.¹⁵¹ Notably, not all of these accounts were being offered to the traditional core unbanked population; at least some were being used for “student” accounts with the expectation that today’s students will graduate into regular account holders. Thus although 85% of accounts were from customers new to the financial institution,¹⁵² this figure includes students with their first bank accounts as well as unbanked adults.

It is possible to calculate the average revenue from Bank On accounts and evaluate their profitability. The accounts had an average monthly balance of \$1,117,¹⁵³ which at a 3% net interest margin suggests annual float income of \$33.51. Additionally, the accounts have monthly fees of \$5, for another \$60 in annual income. And the accounts come with a debit card. The average number of debits per account per month was 27.1,¹⁵⁴ and the average debit transaction amount was \$41.¹⁵⁵ Given that almost all of the accounts involved in Bank On are at large banks¹⁵⁶ that are subject to the Durbin Interchange Amendment’s price cap on debit card interchange fees,¹⁵⁷ the average interchange income for the banks per debit transaction would be \$0.24, resulting in average annual revenue of \$78.05. Thus, in total, the bank would earn \$171.56 in annual revenue from such an account, putting it at the lowest end of revenue needed to break even on an account level basis. (This model will become even more stressed under the Federal Reserve Board’s proposed reduction in the Durbin Interchange Amendment price cap,¹⁵⁸ as debit interchange revenue would fall to \$57.56, meaning that total revenue from the account would be \$151.07.)

Additionally, Bank On accounts exhibit a very high closure rate. Around a quarter of accounts have closed in each program year.¹⁵⁹ The data does not distinguish between voluntary closures, such as a consumer graduating into another type of account or switching financial institutions,

149. *Id.*

150. *Id.* (finding that 3.9 million Bank On accounts were ever opened at community banks out of 17.4 million Bank On accounts ever opened; community banks are defined here as banks having less than \$100 billion in assets).

151. *Id.* (finding that 167,000 Bank On accounts are currently open at community banks out of 8.1 million Bank On accounts currently open).

152. *Id.*

153. *Id.*

154. Gutkowski & Locke, *supra* note 148.

155. *Id.*

156. *See supra* text accompanying notes 150-151.

157. 12 C.F.R. §§ 230.235.3-235.4 (2023).

158. Debit Card Interchange Fees and Routing, 88 Fed. Reg. 78100, 78122 (proposed Nov. 14, 2023) (proposing reducing the base component from 21.0 to 14.4 cents, reducing the ad valorem component from 5.0 basis points to 4.0 basis points, and increasing the fraud-prevention adjustment from 1.0 cents to 1.3 cents).

159. Gutkowski & Locke, *supra* note 148.

and involuntary closures because of failure to pay fees or other account terms violations.¹⁶⁰ Nevertheless, this high level of churn suggests that the costs of onboarding customers into Bank On, including customer identification verification, will take longer to recoup.

Why, then, would a bank ever offer such an account? Bank On's own materials suggest three reasons. First is to develop a "sustainable consumer base" by bringing unbanked consumers into the "financial mainstream."¹⁶¹ This suggests the future possibility of graduating consumers into other types of accounts and/or cross-selling them other products. Second is CRA credit.¹⁶² And third are "community opportunities," essentially positive publicity for banks to get "public recognition both locally and nationally."¹⁶³ CRA credit and positive publicity suggest that the real motivation in offering Bank On accounts is to curry regulatory goodwill.

Although a Bank On account might be a losing proposition on purely monetary terms, the intangible benefit of regulatory goodwill might be substantial enough for banks to offer the product if the total number of accounts, and thus total cost to the bank, is relatively limited. A few million dollars is a cheap way for a large bank to obtain regulatory goodwill, but whether banks will voluntarily offer such a product on a larger scale is unclear.

The most recent pilot program is one by the United States Postal Service that allows consumers to cash payroll and business checks in exchange for stored value cards.¹⁶⁴ The pilot program has been offered at four post office branches. In its first four months, it undertook all of six (!) transactions.¹⁶⁵ While it is not surprising that a little advertised program offered at only four post office branches would get scant usage, the Postal Service's failure to generate interest in its offering does not generate confidence in its ability to successfully offer financial services.

Thus far, federal government pilot projects for banking the unbanked and creating affordable small-dollar loans have had little impact on the scope of financial inclusion. Even by their own terms as proofs of concept, most federal pilot programs have been unsuccessful. The FDIC-inspired Bank On remains the exception, but it is unclear if it can continue to scale, and it only breaks the trilemma for deposit accounts (not credit) because it offers a way to purchase regulatory goodwill, operating as a type of subsidy for banks.

160. *Id.*

161. *Bank on Coalition Playbook*, *supra* note 147, at 22.

162. *Id.*

163. *Id.*

164. See Jory Heckman, *USPS Pilot Expands Postal Banking Services After Years of Skepticism*, FED. NEWS NETWORK (Oct. 4, 2021, 2:17 PM), <https://federalnewsnetwork.com/agency-oversight/2021/10/usps-pilot-expands-postal-banking-services-after-years-of-skepticism> [<https://perma.cc/2EPF-GXHQ>].

165. U.S. POSTAL SERV., ACR2021, RESPONSES OF THE UNITED STATES POSTAL SERVICE TO QUESTIONS 1-2 OF COMMISSION INFORMATION REQUEST NO. 1, at 7 (2022).

B. Other Potential Regulatory Interventions

The United States has mainly relied on private provision of deposit, payment, and small-dollar credit services, supplemented with negative mandates and soft mandates. The failure of this light touch approach suggests that more muscular regulatory interventions should be considered if the United States is serious about addressing its financial inclusion problem.

There are three stronger regulatory approaches that could be taken: hard service mandates, public options, and public subsidies. Each of these can be understood as an approach that prioritizes widespread access and fairness of terms over stand-alone profitability, but the way they operate is quite different. This section reviews each in turn, but the basic assumption of this section is that any solution to the trilemma must focus on loosening the stand-alone profitability requirement.

The other two requirements—widespread access and fairness of terms—are fundamental to the entire idea of financial inclusion. If access is not widespread, it is not meaningful inclusion, and if terms are not fair, the inclusion is not worth pursuing. That leaves the stand-alone profitability requirement to consider.

Although the need for stand-alone profitability has long been a policy assumption, it is not fundamental to the idea of financial inclusion, and insisting upon it is what creates the trilemma. Instead, the stand-alone profitability requirement reflects a general political discomfort with subsidization of consumer financial services. Yet there is something pearl-clutching in this unease given that the U.S. banking system hardly operates as a “free market.” For example, regulators control entry into the market as well as mergers and acquisitions, impose capital and liquidity requirements, and (for many banks) require participation in a mutual insurance program. Banks are able to function solely because of a highly (if not always perfectly) regulated environment that makes it possible for customers to rely on the safety-and-soundness of fractional reserve banks. Thus, it is the stand-alone profitability requirement that should be examined as the leg of the trilemma that can be potentially addressed through a regulatory fix.

1. Hard Service Mandates

One stronger regulatory approach is a hard service mandate. In contrast with a soft mandate like the CRA, a hard mandate would require banks to provide certain services at certain terms, irrespective of their stand-alone profitability, effectively imposing a cross-subsidization requirement.

An example of a hard mandate would be a basic banking requirement obliging all banks to offer low-fee or free checking accounts to certain

consumers. Given that a special license is required to engage in banking activities,¹⁶⁶ it is well within the purview of the government to condition such a license on provision of services seen to be in the public interest.

The United States lacks any sort of hard service mandate, distinguishing it from several other developed countries. From 2003 to 2018, Canada's Bank Act required banks to open a "low-fee retail deposit account" with no minimum balance requirement for any individual that meets the regulatory requirements.¹⁶⁷ The only regulatory exceptions related to fraud, illegality, and customer abuse; bankruptcy (and presumably the consumer's credit score) was not grounds for refusing to open an account.¹⁶⁸ Such accounts had to allow at least twelve debit transactions per month, at least two of which could be done in-branch, as well as check-writing privileges.¹⁶⁹ For these low-fee retail deposit accounts, banks could not charge for deposits, debit cards, pre-authorized payments, monthly printed statements, or online check image viewing.¹⁷⁰ For most low-fee retail deposit accounts, a four Canadian dollar per month fee was authorized, and other services may have been offered "for a reasonable fee."¹⁷¹ Youths, students, the poor, seniors, and certain disabled persons were eligible for free accounts under the implementing regulations.¹⁷²

In 2018, Canada repealed this statutory mandate¹⁷³ and replaced it with a looser one that merely requires the opening of an account without an initial minimum deposit or minimum balance requirement upon presentment of adequate documentation, subject to the same fraud, illegality, and customer abuse exceptions.¹⁷⁴ Although Canada no longer requires that the accounts be "low-fee," the Canadian government has entered into voluntary commitments with Canada's ten largest banks to offer such low-fee accounts on the same terms as before 2018.¹⁷⁵

166. As a technical matter, no federal law prohibits unlicensed deposit taking and lending, only the misleading use of "national" in the name of a banking business. 18 U.S.C. § 709 (2018). Instead, federal law only prohibits unlicensed money transmission. 18 U.S.C. § 1960 (2018). State law often prohibits unlicensed banking. *See, e.g.*, CAL. FIN. CODE § 1005 (West 2023); N.Y. BANKING LAW § 131 (LexisNexis 2023); MD. CODE ANN., FIN. INST. § 3-208 (West 2023); MASS. GEN. LAWS ch. 167, § 37 (2023).

167. S.C. 1991, c 46, §§ 448.1-2 (Can.), repealed 2018, c.27 § 31 (Can.).

168. Access to Basic Banking Services Regulations, SOR/2003-184, § 3(1)-(2) (Can.).

169. *Id.*

170. *Low-Cost Account Guidelines*, FIN. CONSUMER AGENCY OF CAN. (Jan. 9, 2017), <https://www.canada.ca/en/financial-consumer-agency/services/industry/laws-regulations/low-cost-account-guidelines.html> [<https://perma.cc/HPS2-BSRS>].

171. *Id.*

172. *Id.*

173. S.C. 1991, c 46, § 627.17(1) (Can.), as amended by 2018 .c 27 ¶ 329 (Can.).

174. S.C. 1991, c 46, § 627.18 (Can.), as amended by 2018 .c 27 ¶ 329 (Can.).

175. *Low-Cost and No-Cost Accounts*, FIN. CONSUMER AGENCY OF CAN. (June 26, 2023), <https://www.canada.ca/en/financial-consumer-agency/services/banking/bank-accounts/low-cost-no-cost.html> [<https://perma.cc/76NA-RLD4>]. *See also, e.g., Low-Cost and No-Cost Account*

The European Union has had a fee-free banking account mandate since 2015,¹⁷⁶ and the United Kingdom has one originally adopted in anticipation of the EU mandate, but retained after the UK left the EU.¹⁷⁷ Notably, the EU and UK mandates do not require all banks to offer free or low-fee bank accounts. Instead, the EU mandate requires EU member states to apply the mandate to either all banks or to “a sufficient number of credit institutions to guarantee access thereto for all consumers in their territory”¹⁷⁸ Similarly, the UK mandate applies only to the nine largest banks in the UK,¹⁷⁹ all of which offer free basic accounts, but without overdraft credit facilities.¹⁸⁰

In the United States, such low-fee retail deposit accounts would be money losers for banks. In order to offer them, banks would have to engage in cross-subsidization, either by charging their other customers more or by accepting reduced profitability. A hard mandate is thus a cross-subsidization requirement. The details of the cross-subsidy are left up to the individual bank, enabling the government to avoid the question of how to distribute the cost of the mandate.

One concern with a hard service mandate is that banks will drag their feet and attempt to create frictions to discourage consumers from seeking out money-losing accounts with them.¹⁸¹ Here, a benchmarking law like the

Commitment, BMO BANK OF Montreal 1, https://www.bmo.com/pdf/9628183LowCostAccounts_en2.pdf [<https://perma.cc/3JJ5-2HJE>]. Canada has a much more concentrated banking market than the United States. The country’s six largest banks hold around 93% of all Canadian banking assets. Ian Bickis, *How Big Banks Dominate Canada’s Financial Landscape*, GLOBAL NEWS (Apr. 19, 2023, 6:40 AM), <https://globalnews.ca/news/9634933/canada-big-banks-analysis> [<https://perma.cc/VVD5-M8L7>].

176. Council Directive 2014/92, art. 17-18 2014 O.J. (L 257) (EC) [hereinafter EU Payment Accounts Directive].

177. Payments Account Regulation 2015, SI 2038, art. 20, ¶ 1 (requiring provision of fee-free accounts); *Basic Bank Accounts: January to June 2016*, HM TREASURY 4 (Dec. 2016), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/576033/Basic_bank_account_2016_dec_final.pdf [<https://perma.cc/7WCH-3KU2>] (discussing the voluntary nature of the UK arrangement, but stating that it was made in anticipation of the EU Payment Accounts Directive becoming effective in the UK); *Basic Bank Accounts: July 2020 to June 2021*, HM TREASURY 3 (Jan. 2022), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1049371/Official_Sensitive_-_Basic_bank_account_report.pdf [<https://perma.cc/E28E-2PX3>] (discussing application of basic bank account mandate to the largest UK banks, which collectively hold ninety percent of deposit accounts in the country); *Payment Accounts (Amendment) (EU Exit) Regulations 2018: Explanatory Information*, HM TREASURY (Oct. 31, 2018) <https://www.gov.uk/government/publications/draft-payment-accounts-amendment-eu-exit-regulations-2018/payment-accounts-amendment-eu-exit-regulations-2018-explanatory-information> [<https://perma.cc/AA6L-AJ2N>] [hereinafter EU Exit Regulations Explanatory Information].

178. EU Payment Accounts Directive, *supra* note 176 at art. 16(1).

179. *UK Compliance with the EU Payment Accounts Directive*, HM TREASURY (Sept. 18, 2016), <https://www.gov.uk/government/publications/uk-compliance-with-the-eu-payment-accounts-directive/uk-compliance-with-the-eu-payment-accounts-directive> [<https://perma.cc/E82F-HLHH>].

180. EU Exit Regulations Explanatory Information, *supra* note 177.

181. See Lauren E. Willis, *When Nudges Fail: Slippery Defaults*, 80 U. CHI. L. REV. 1155, 1185-1200 (2013) (providing examples of how banks have found ways to discourage consumers from not opting in to for-fee overdraft coverage).

CRA could come into play, measuring banks' success in providing low-fee retail deposit accounts. Additionally, while the unbanked themselves might find signing up for an account daunting, social workers and aid agencies could be instrumental in getting unbanked individuals signed up for accounts.

2. Public Options

Another path to financial inclusion is through public provision of financial services—public options. Historically, the United States offered a public option for deposit services. From 1911 until 1967, the United States Postal Savings System (USPSS) offered interest-bearing passbook savings accounts.¹⁸²

The USPSS was not intended to be a financial inclusion vehicle. Instead, it was created as the Republican-favored alternative to federal deposit insurance.¹⁸³ Hence the USPSS's sole offering was a passbook savings account,¹⁸⁴ a relatively rare product today. In a passbook savings account, the consumer does not receive periodic balance statements.¹⁸⁵ Instead, the consumer receives a passbook—a small, passport-like booklet. Whenever the consumer wishes to transact, the consumer presents the passbook to the bank, which records the transaction and the account balance before returning it to the consumer, a process that requires the consumer to complete all transactions in person at the bank. Passbook savings accounts provide safekeeping services, but nothing more.¹⁸⁶ Passbook savings accounts are essentially piggybanks. They cannot be used to make payments, so they do not actually connect unbanked consumers to the modern commercial world.

In recent years, there has been a call from progressive academics for pursuing financial inclusion through retail-facing public options.¹⁸⁷

182. Postal Savings Depository Act of 1910, Pub. L. No. 61-268, 36 Stat. 814 (1910) (creating Postal Savings System); Pub. L. No. 89-377, § 5225, 80 Stat. 92, 92 (1966) (terminating Postal Savings System).

183. See Gerhard Peters & John T. Woolley, *Republican Party Platform of 1908*, AM. PRESIDENCY PROJECT, <https://www.presidency.ucsb.edu/documents/republican-party-platform-1908> [<https://perma.cc/4SWQ-5B89>]. In contrast, Democrats supported a postal bank only as a second-best alternative to federal deposit insurance. See Gerhard Peters & John T. Woolley, *1908 Democratic Party Platform*, AM. PRESIDENCY PROJECT, <https://www.presidency.ucsb.edu/documents/1908-democratic-party-platform> [<https://perma.cc/CL2S-HGEL>].

184. Pub. L. No. 61-268, 36 Stat. 814, 817 (1910).

185. 12 U.S.C. § 1693d(d) (2018); 12 C.F.R. § 1005.9(c)(1) (2023).

186. See LEVITIN, *supra* note 52, at 258.

187. The USPSS was a rare retail-facing public option, but there is substantial public provision of financial services in secondary or wholesale markets. Thus, there is already federal provision of mortgage insurance for lenders, deposit insurance for banks, and securitization guaranties for mortgage-backed securities investors. There is also federal provision of payment systems: the Federal Reserve System operates a check clearing network, a wire transfer service (FedWire), and an automated clearinghouse network (FedACH). In 2023, the Federal Reserve System added a real-time payment system called FedNow. None of these payment systems are

Professor Mehrsa Baradaran has advocated for a renewed postal banking system,¹⁸⁸ while Professors Morgan Ricks, John Crawford, and Lev Menand have called for the provision of free bank accounts (FedAccounts) by the Federal Reserve.¹⁸⁹ Both proposals are focused on the provision of deposit services, but hold open the possibility of credit services as well. One proposed legislative implementation of a renewed postal banking system would have a postal bank offering loans at the one-month constant maturity Treasury rate,¹⁹⁰ currently 5.53%, but as low as 0.01% in recent years. As we have seen, however, there is no way to make such loans profitably, so there would necessarily be a taxpayer subsidy. Once again, widespread access and fair terms cannot be paired with stand-alone profitability, only with subsidized economics.

3. Public Subsidies

A final potential approach to financial inclusion is through direct public subsidies of banks. A subsidy would function to reimburse banks for provision of services that they would not otherwise offer. A public subsidy could be done on a stand-alone basis or be combined with a hard mandate.

A key difference in approaches among a hard mandate, public provision, and a direct subsidy is who pays for financial inclusion. An unsubsidized hard mandate imposes a progressive cross-subsidy from banked to unbanked or underbanked consumers or from bank shareholders to unbanked or underbanked consumers, per the business judgement of each bank. Public provision places costs in the first instance on the users of the service, but any shortfalls are necessarily borne by taxpayers. In contrast, a public subsidy is distributed among taxpayers through the Internal Revenue Code.

If implemented on a stand-alone basis, the subsidy would have to be large enough to motivate banks to provide the service—that is, it would have to make service provision profitable, and the subsidy’s continued availability would have to be sufficiently credible for banks to be willing to invest given their upfront costs. If combined with a hard mandate, the subsidy could be smaller. Having a subsidy would at least partially offset any need for cross-subsidization, which might make the hard mandate

accessed by retail customers—consumers and businesses—directly. Instead, they are all accessed by financial institution intermediaries.

188. Baradaran, *supra* note 17, at 211-13. See also Adam J. Levitin, *Going Postal: Financial Inclusion via Postal Banking* (Working Paper 2011) (providing a history of postal banking).

189. John Crawford, Lev Menand & Morgan Ricks, *FedAccounts: Digital Dollars*, 89 GEO. WASH. L. REV. 113, 113 (2021); Morgan Ricks, John Crawford & Lev Menand, *Central Banking for All: A Public Option for Bank Accounts*, ROOSEVELT INST. GREAT DEMOCRACY INITIATIVE (June 2018), https://rooseveltinstitute.org/wp-content/uploads/2021/08/GDI_Central-Banking-For-All_201806.pdf [<https://perma.cc/CC9P-MPMC>].

190. Postal Banking Act, S. 2755, 115th Cong. (2018); Postal Banking Act, S. 4614, 116th Cong. (2020).

more politically acceptable, because other bank customers would not perceive themselves as bearing the cost of financial inclusion.

Federal subsidization is a well-established tool in consumer finance markets. The federal government subsidizes mortgage insurance through the Federal Housing Administration, Veterans Agency, and U.S. Department of Agriculture Rural Development. It also subsidizes student loans through the Stafford Student Loan Program. And it subsidizes rent through Section 8 vouchers.

There is already small-scale subsidization of transaction accounts. The Debt Collection Improvement Act of 1996 required that all federal payments made after January 1, 1999 be made electronically, subject to certain exceptions.¹⁹¹ It also provided that Treasury ensure that federal payment beneficiaries have access to an account “at a reasonable cost” and “the same consumer protections with respect to the account as other account holders at the same financial institution.”¹⁹²

For federal benefit recipients with bank accounts, this is easy enough; Treasury simply transfers funds to their accounts via ACH transactions. But for the unbanked, electronic payments are not possible. Treasury first attempted to address the electronic payment requirement through subsidized Electronic Transfer Accounts at banks and credit unions. The program was not successful. In its first two years, it produced only 8,100 accounts at some 600 institutions.¹⁹³

Starting in 2008, Treasury retooled its approach.¹⁹⁴ Instead of making subsidy payments to numerous banks based on account openings, it instead contracted with a single bank (Comerica Bank) for the issuance of reloadable prepaid debit cards under what is known as the Direct Express program.¹⁹⁵ Direct Express disburses Social Security and Veterans benefits to some 4.5 million unbanked consumers.¹⁹⁶ The benefit payments are automatically loaded onto beneficiaries’ Direct Express cards, which can then be used like a debit card at any store that accepts Mastercard

191. Debt Collection Improvement Act, Pub. L. No. 104-134, § 31001(x) 110 Stat. 1321-376 (1996) (codified at 31 U.S.C. § 3332(f) (2018)).

192. *Id.* at 1377 (codified at 31 U.S.C. § 3332(i)(2)(B) (2018)).

193. Stegman et al., *supra* note 130, at 406-07.

194. U.S. GOV’T ACCOUNTABILITY OFF., GAO-17-176, REVENUE COLLECTIONS AND PAYMENTS: TREASURY HAS USED FINANCIAL AGENTS IN EVOLVING WAYS BUT COULD IMPROVE TRANSPARENCY 13 (2017).

195. *Treasury’s Bureau of the Fiscal Service Selects Comerica Bank to Continue Prepaid Debit Card for Unbanked*, U.S. DEP’T OF THE TREASURY, BUREAU OF THE FISCAL SERV. (Jan. 7, 2020), <https://www.fiscal.treasury.gov/news/comerica-bank-continues-debit-card-for-unbanked.html> [<https://perma.cc/FA7Q-TLG6>].

196. *Id.* Most of the benefits distributed are Supplemental Security Income or Social Security Retirement benefits. *A Look at Cardholder Demographics*, DIRECT EXPRESS (June 13, 2019), <https://directexpress.info/2019/06/13/a-look-at-cardholder-demographics> [<https://perma.cc/49QT-GXMC>].

products.¹⁹⁷ The Direct Express card can also be used to make ATM withdrawals or get extra cash back on purchases.¹⁹⁸ The card has no fixed fees, but allows only one free ATM withdrawal per month.¹⁹⁹ It also allows balance transfer inquiries and text messages when funds are deposited or balances fall below a specified threshold.²⁰⁰ Only Treasury, however, can load funds onto the card; the cardholder cannot load the card with funds from other sources.

Direct Express did not originate as a financial inclusion program, but as a response to a congressional directive to move to electronic payments of government benefits for efficiency purposes. Nevertheless, Direct Express functions as a form of subsidized financial inclusion; in 2019, 70% of Direct Express cardholders reported that they do not have a bank account.²⁰¹ Treasury shoulders the cost of the Direct Express program, which provides some level of financial inclusion for Direct Express cardholders. It is not the perfect financial inclusion product, particularly because it allows access solely to funds disbursed by Treasury, but it is an important example of subsidized financial inclusion that could potentially be expanded.²⁰²

IV. Choosing the Optimal Regulatory Intervention

The previous Parts have argued that private provision and soft mandates have proven insufficient for addressing the problem of financial inclusion and that more muscular interventions—whether hard mandates, public provision, or public subsidies—are required. A key point of this Article, however, is that the unbanked and underbanked represent fundamentally different public policy problems, such that they are unlikely to be solved through the same approach. Instead, each problem needs to be evaluated on its own terms, as this Part proceeds to do.

A. Interventions for the Unbanked

A hard mandate, a public option, or a public subsidy can all, in the abstract, significantly reduce the number of unbanked households by providing free or low-cost accounts, irrespective of household credit

197. *Direct Express*, U.S. DEP'T OF THE TREASURY, BUREAU OF THE FISCAL SERV. (May 2, 2023), <https://www.fiscal.treasury.gov/directexpress> [<https://perma.cc/J2LL-PQEH>].

198. *Id.*

199. *Id.*

200. *Id.*

201. *A Look at Cardholder Demographics*, *supra* note 196.

202. Adam J. Levitin, Lindsey Owens & Ganesh Sitaraman, *No More Bailouts: A Blueprint for a Standing Emergency Economic Resilience and Stabilization Program*, ROOSEVELT INST. GREAT DEMOCRACY INITIATIVE 28 (June 2020), <https://ssrn.com/abstract=3639607> [<https://perma.cc/27XK-UA5S>]; Prasad Krishnamurthy, *Stimulus for All*, HILL (May 14, 2021, 6:00 PM), <https://thehill.com/opinion/finance/553620-stimulus-for-all> [<https://perma.cc/4UH4-LTR3>].

quality. Yet there are reasons to prefer a hard mandate for provision of basic banking services over either public options or public subsidies.

A hard mandate for provision of basic banking services has the virtues of being both the most direct tool and the one without any cost to the public fisc or administrative costs. With a mandate for the provision of basic banking services, the government can specify precisely the product terms it wants and not worry about funding it; the funding will be left up to each individual bank, which will have to decide whether and how to cross-subsidize from other product offerings or shareholder surplus. Presumably, the cross-subsidy will be borne by the least competitive market.

In contrast, a public option lets the government craft the terms on which it wishes to offer services, but has a direct cost to the public fisc and huge administrability challenges. While it might be possible to structure a public option that resides off the federal balance sheet, such as through the Postal Service²⁰³ or the Federal Reserve System, this is an accounting measure; the public still pays for it. The Postal Service receives a standing appropriation of all revenues it receives²⁰⁴ and has received supplemental congressional appropriations,²⁰⁵ while the Federal Reserve remits its profits to Treasury's general fund.²⁰⁶ An increase in operating expenses for either could necessitate further appropriations or result in a smaller remittance to Treasury.

Additionally, any sort of public option would require substantial lead time to implement and would pose enormous operational challenges. The federal government generally does not provide retail financial services itself but instead provides secondary market services. The major exception is student lending, but even there, the loans are made by the federal government and disbursed to schools instead of students,²⁰⁷ the disbursement is handled by a private contractor,²⁰⁸ and the loans are serviced by private servicers, rather than the Department of Education itself.²⁰⁹ Nor are direct student loans underwritten in any traditional sense;

203. 39 U.S.C. § 2009a (2018).

204. 39 U.S.C. § 2401(a) (2018).

205. CARES Act, Pub. L. No. 116-136, § 6001, 134 Stat. 281, 504 (2020) (providing a \$10 billion loan appropriation for the Postal Service); Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, § 801, 134 Stat. 1182, 2119 (2021) (providing that the Postal Service is not required to repay its borrowing under the CARES Act).

206. 12 U.S.C. § 289(a)(3)(B) (2018) (requiring any surplus in the Federal Reserve System above \$6.825 billion to be remitted to Treasury's general fund).

207. *Receiving Financial Aid*, U.S. DEP'T OF EDUC, FED. STUDENT AID, <https://studentaid.gov/complete-aid-process/receive-aid> [<https://perma.cc/ERJ9-235A>].

208. *See Accenture Awarded \$966 Million Contract to Support Federal Student Aid Programs*, ACCENTURE (Apr. 16, 2015), <https://newsroom.accenture.com/news/accenture-awarded-966-million-contract-to-support-federal-student-aid-programs.htm> [<https://perma.cc/9KA9-D84G>].

209. John R. Brooks & Adam J. Levitin, *Redesigning Education Finance: How Student Loans Outgrew the "Debt" Paradigm*, 109 GEO. L.J. 5, 50 (2020).

pricing is one-size-fits-all.²¹⁰ Simply put, there is no federal experience in managing a large-scale retail financial operation. This is not to say that it cannot be done, but that it presents a significant complication for any public option.

Another problem with a public option is that it puts the government in a potentially adverse position to consumers. Because bank accounts can be overdrawn, a public option means that the government is potentially in the position of being a creditor to low-income households. This raises thorny questions about how collection activities would work. For example, would the government set off overdrawn accounts against earned income tax credits? If the government is a service provider, it is unavoidable that there will be some situations in which it is adverse to the consumer.

If government is accepting deposits, there is also an unavoidable question of how those deposits will be invested. Historically, the USPSS addressed the issue by requiring that deposits either be invested in Treasury securities or redeposited in local commercial banks.²¹¹ By being a depository, however, the federal government would face a question about how it would allocate capital—whether to itself or elsewhere.

Finally, a public option in banking threatens all manner of disruption and disintermediation with attendant unintended consequences. If government accounts have attractive features, money will flow out of the private system to them. Whether this is a feature or bug depends on the goals of a public option.

If the goal of a public option is to compete with private banks and set a market benchmark, then disintermediation is a feature—it is exactly what should happen until and unless private banks adjust. But if the goal of a public option is merely to supplement the private banking system and serve only otherwise unserved customers, then the disintermediation is a bug. To the extent that a public option is really just about financial inclusion, not reshaping the terms on which banks offer services generally, disintermediation is a bug.

The risk of disintermediation is hardly speculative. For example, the USPSS caused huge disintermediation of funds from building-and-loan institutions during the Great Depression, exacerbating the collapse of the housing market with its requirement of deposit reinvestment in commercial banks (which did little real estate lending) or Treasuries.²¹² When depositors fled building-and-loans for the safety of the USPSS, their money left the housing finance system, pushing up mortgage costs and

210. *Id.* at 35-36.

211. Pub. L. No. 61-268, § 9 36 Stat. 814, 816 (1910).

212. *Id.*; Maureen O'Hara & David Easley, *The Postal Savings System in the Depression*, 39 J. ECON. HIST. 741, 746-49 (1979).

pulling down housing values.²¹³ A public option could be majorly destabilizing to financial markets because of such unanticipated dynamics.

The third possibility—public subsidies for bank accounts—could be coupled with a hard mandate, but could also be pursued on a stand-alone basis. On a stand-alone basis, it is the least attractive option. Public subsidies do not guarantee the offering of any services unless the subsidies are larger than the cost of offering the services. In other words, the government would, by definition, have to overpay in order to be sure that subsidies would be effective.

If the subsidies come out of annual appropriations, they would also add an element of uncertainty because future appropriations would not be guaranteed. This uncertainty would discourage financial institutions from investing in the capacity to offer accounts that would qualify for the subsidies. To be sure, such subsidies could come directly from fees or taxes levied on banks through the chartering or insurance process, or could be given as a credit against such fees. This would have much the same effect as the cross-subsidization imposed by a hard mandate.

A subsidy system would also require some type of administrative apparatus to ensure that the payment of the subsidies accorded with the number of accounts provided. While a subsidy system would necessitate a far smaller administrative apparatus than a public option, none is needed for a hard mandate.

All of this counsels for a hard mandate for provision of basic banking services as the prime policy move for addressing the problem of the unbanked. As a political matter, such a mandate might be more likely to be enacted if it exempted community banks or if it were coupled with an offsetting subsidy, but that is a political point, rather than a fundamental system design point.

While there are policy tools for substantially addressing the problem of the unbanked, the underbanked are a different story, as the next section addresses.

B. Interventions for the Underbanked

The key problem of the underbanked—the demand for short-term, small-dollar credit—is not one that can generally be resolved by government intervention. The demand for short-term, small-dollar credit is partially a demand for consumption-smoothing liquidity, but it is also partially reflecting consumers attempting to address the fundamental mismatch between their income and their expenses.

To the extent that the demand is merely for bridge liquidity, there are government interventions that can help. For example, allowing advances

213. O'Hara & Easley, *supra* note 212, at 748-49.

of the earned income tax credit or earned wage access products²¹⁴ or more regular disbursement of government benefits would provide a source of liquidity smoothing.²¹⁵

To the extent the demand is driven by solvency problems, then facilitating greater credit availability is not a solution.²¹⁶ Credit cannot bridge a solvency problem. As long as the solvency problem persists, expanding access to credit is likely to be welfare reducing for many consumers.²¹⁷

Moreover, interventions like hard mandates, public subsidies, or a public option put the government in the awkward position of either directing credit provision (hard mandates and public subsidies) or engaging in direct credit provision (public options). Either way risks the politicization of government lending programs. There would be a constant temptation for those in power to attempt to curry favor with voters through easier lending terms, ultimately undermining the soundness of underwriting. Additionally, to the extent the government makes loans, it has to collect them, putting the government in an adverse position to the very consumers it aims to help.

To be sure, these risks also exist for existing government credit programs in the home mortgage and student loan markets. But there are offsetting benefits for the public in those markets—the social stability that comes from homeownership and the benefits of a better educated population. Furthermore, in the housing market, the problem of politicization is mitigated by having the government operate mainly as a secondary market and insurance provider, rather than a direct credit provider. It is hard to see any benefit to the public from having cheaper sources of short-term, small-dollar lending that can be spent without restriction.

Ultimately, household solvency problems can only be addressed by secular changes in the economy that will result in greater income and lower expenses for households and greater savings rates that can provide cushion

214. See Nakita Q. Cuttino, *The Rise of “FringeTech”: Regulatory Risks in Earned-Wage Access*, 115 NW. U. L. REV. 1505, 1505-06 (2021) (proposing a regulatory framework to mitigate risks in earned-wage access products).

215. See Yonathan A. Arbel, *Payday*, 98 WASH. U. L. REV. 1, 14-16 (2020) (discussing how more regular payment of wages would help consumer liquidity management). See also Yesha Yadav, *FedNow or FedLater?*, BANKING RISK & REGUL. (Aug. 10, 2023), <https://www.bankingriskandregulation.com/fednow-or-fedlater> (on file with author) (suggesting that a lack of accessible real-time payments in the United States imposes costs on the unbanked and underbanked). Again, if the economic problem faced by the unbanked or underbanked is one of lack of funds, rather than lack of liquidity, it is not clear why accessible real-time payments would be a solution.

216. See Abbye Atkinson, *Rethinking Credit as Social Provision*, 71 STAN. L. REV. 1093, 1098-99 (2019).

217. *Id.*

against unexpected expenses.²¹⁸ Regulation can play a key role in changing the shape of the economy, but it is not primarily consumer finance regulation that is involved.

At best, the role consumer finance regulation can play in small-dollar credit markets is to lower costs through structural changes in markets, such as moving borrowers away from short-term, non-amortizing rollover products to longer-term, prepayable, amortizing installment loans.²¹⁹ Regulation can mitigate costs, not eliminate them, because it cannot eliminate demand. This still leaves us, then, with the trilemma for small-dollar credit. The terms of small-dollar credit can be made more palatable, but the fundamental economics of small-dollar lending means that the product will never be cheap.

Balancing the imperatives of access and fairness in small-dollar credit markets remains one of the thorniest policy decisions in consumer finance. Recognizing that there is no easy solution to small-dollar credit, we can still aim to achieve greater financial inclusion in deposit account markets, but doing so will require disentangling these two very different types of financial inclusion problems.

Conclusion

Financial inclusion has been a policy priority in the United States for decades, but there is still little to show for it: many households remain unbanked, and many more are underbanked. The financial inclusion problem cannot be solved by private provision, even with the deployment of new technologies, because the economics of small-dollar deposits and small-dollar lending make it impossible to simultaneously offer these products on a wide scale, fairly, and profitably on a stand-alone basis. This is the financial inclusion trilemma.

For the unbanked, the trilemma can be addressed by loosening the profitability constraint through subsidization in one form or another—whether directly or indirectly through appropriations or by mandating cross-subsidization by private parties. For the underbanked, however, financial inclusion remains a thornier problem that can only be fully addressed through broader changes in the U.S. economy.

218. See generally ELIZABETH WARREN & AMELIA WARREN TYAGI, *THE TWO INCOME TRAP: WHY MIDDLE-CLASS PARENTS ARE GOING BROKE* (2004); JACOB S. HACKER, *THE GREAT RISK SHIFT: THE NEW ECONOMIC INSECURITY AND THE DECLINE OF THE AMERICAN DREAM* (2d ed. 2008).

219. See PEW CHARITABLE TRUSTS, *supra* note 85, at 12 (noting how Colorado's 2011 payday loan reforms resulted in lower costs to borrowers, despite increasing authorized fees, by changing the structure of the industry so that lenders could better compete on price).