Chapter 10: Access and Inclusion

Increasing financial access and inclusion is a moral imperative. All Americans should have access to an array of product choices offered in competitive and transparent markets with prices and terms set through the voluntary exchange of willing providers and willing demanders. Low-income and young consumers, citizens and immigrants, men and women—all Americans have an inalienable right to be treated with dignity and respect, to be protected from invidious discrimination, and to be trusted to make the choices that they consider to be best for them under the circumstances they face.

Increased financial access is also sound practical policy that promotes household financial security, economic empowerment, and macroeconomic growth and stability. Financial inclusion also presents distinct policy challenges. In many instances the circumstances that low-income, young, minority, and immigrant households face are very different from those of established, middle-aged households. And the needs and circumstances of individuals within those groups can be highly heterogeneous as well.

"Money is a great power because… it is a frozen form of productive energy."[1] In the modern economy, access to financial products and services is a necessary ingredient to improving one's life, health, and well-being. Consumer access to bank accounts, savings accounts, mortgages, student loans, auto loans, credit cards, retirement accounts, and other financial products are vehicles to build wealth, provide financial security, and acquire the personal capital that provides the raw material for economic success and human flourishing. Those who are excluded from the financial system are excluded from

[1] Ayn Rand, *The Sanction of the Victims*, *in* THE VOICE OF REASON: ESSAYS IN OBJECTIVIST THOUGHT 149, 154 (1990).

those benefits; indeed, they are unable to gain the first toehold on the economic ladder that will pull them into the middle class.

Today, unlike even 50 years ago when the National Commission on Consumer Finance (NCCF) reviewed the consumer finance landscape, we live in an era in which hundreds of millions of Americans take for granted the ability to access a wide array of high-quality financial services available 24 hours a day from the convenience of their desktop or phone. Most American families have dozens of financial providers offering quality, innovative solutions to their financial needs, and new innovations arriving every day. As author Lewis Mandell has observed, "With a credit card, you can buy yourself a new car. Without it, you cannot even rent one."[2]

But today there is a minority of the population who remain outside the mainstream financial system, unable to access the first rung on the ladder to financial inclusion and empowerment. In some instances, this decision is by choice, because of distrust of banks or, in some instances, less benign motivations such as to conceal illegal or other improper activities. But in many other instances consumers desire access to financial products but find them to be too expensive or otherwise unavailable, often because of government regulations. Although largely invisible to middle-class Americans, these regulations provide daily hurdles to greater financial access for millions of minority, younger, and immigrant families.

Providing access to quality financial services at reasonable prices was one of the four great themes of the NCCF Report, along with competition, consumer protection, and promoting informed consumer choice. The NCCF concluded that the primary barrier to

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[2] LEWIS MANDELL, THE CREDIT CARD INDUSTRY: A HISTORY at xi (1990).

more widespread financial inclusion was government regulations and limits on competition and entry that interfered with the ability of companies voluntarily to transact with a wider array of consumers in a competitive market. Foremost among those barriers was long-standing legal restrictions on permissible interest rates, so-called "usury" ceilings and accompanying regulatory barriers to entry.

In the period since that time, the financial system made great strides in expanding access to individuals and groups who traditionally were unable to gain access to financial services. In predominant part this growth in access arose from reforming or eliminating many of the historical regulatory barriers that stood in the way of financial institutions providing access to financial products. Once those barriers were eliminated or attenuated, market forces naturally drove a process of seeking out new customers, many of whom were traditionally underserved. Technological innovations, most notably the evolution of credit reporting, helped financial services providers to identify new groups of underserved consumers. Finally, federal legislation, regulation, and enforcement in the area of fair lending has been designed to root out remaining areas of discrimination. Other new regulations enacted in the aftermath of the 2008 financial crisis have increased the cost and reduced accessibility of financial products for many Americans.

This chapter surveys these forces. We start by examining the underlying dynamics that drive the challenge of financial inclusion. We then review the history of financial inclusion in the United States and traditional economic and regulatory barriers to greater financial inclusion. This discussion builds on Chapter 5's discussion of small-dollar loans and credit rationing. For much of American history, elites have been skeptical of the value of financial inclusion for non-elites. Working-class individuals were seen as profligate, impulsive, and easily tempted into living beyond their means. Crude and unfounded stereotypes based on class, race, and sex were invoked to support paternalistic protections on categories of consumers. Eliminating these barriers and the stereotypes that rationalized them was a primary focus of the NCCF Report. Although economically informed consumer advocates and scholars had long recognized the value of access to financial products, efforts to reform laws and regulations have met with opposition from many legislators and paternalistic advocacy groups.

Finally, the chapter turns to examine the current state of affairs, focusing particularly on the impact of legislative and regulatory actions taken in the period following the 2008 financial crisis and closes with a discussion of steps policymakers could take to promote greater inclusion, access, competition, and innovation.

I. Financial Inclusion and Its Limits

Expansion of access to financial services has long been understood as a primary goal of government policy. As noted by the NCCF, one of the vital roles of the legislator in the area of consumer credit is "to assure access *by all*" to alternative sources of credit offered in competitive markets.[3] This mandate is codified in Dodd-Frank in the "Objective" that the CFPB should ensure that "markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation."[4] In addition, in any rulemaking the Bureau is instructed to consider the "potential benefits

[3] *See* NATIONAL COMMISSION ON CONSUMER FINANCE, CONSUMER CREDIT IN THE UNITED STATES 2 (Dec. 1972).
[4] 12 U.S.C. §5511(b).

and costs to consumer and covered persons, including the potential reduction of access by consumers to consumer financial products or services resulting from such rule."[5]

A. What is Financial Inclusion?

"Financial inclusion" and "financial access" are terms and concepts that are often invoked but not always well defined. The World Bank provides a useful working definition[6]:

> Financial inclusion means that individuals and businesses have access to useful and affordable financial products and services that meet their needs—transactions, payment, savings, credit and insurance—delivered in a responsible and sustainable way.
>
> Being able to have access to a transaction account is a first step toward broader financial inclusion since a transaction account allows people to store money, and send and receive payments. A transaction account serves as a gateway to other financial services….

In the United States, access to a "transaction account" traditionally has required a bank account. Beyond access to bank accounts, financial inclusion usually also means access to mainstream consumer financial products, such as credit cards, auto finance, and mortgage credit. But technological innovation is challenging this traditional intuition, as fintech products increasingly supplant the roles played by many of the familiar instruments, creating an opportunity for the development of highly personalized products tailored to specific consumers and beyond the traditional binary distinctions between alternative and mainstream products or between prime and subprime products.. Unconstrained by the traditional limits of geographic proximity to customers, fintech products bring the dynamics of "the long tail" to consumer financial products just as it

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[5] 12 U.S.C. §5512(b)(2)A)(i).

[6] WORLD BANK, FINANCIAL INCLUSION: OVERVIEW, *available in* https://www.worldbank.org/en/topic/financialinclusion/overview.

has to other products, allowing the development of ever more fine-grained product offerings that belie the traditional lumpy distinction between "inclusion" and "exclusion" or "mainstream" and "alternative" products. This suggests a broader and more nuanced understanding of financial inclusion may be appropriate in the future beyond simply having a bank account.

It is not necessary for the Taskforce to resolve the question of how to define "financial inclusion" or how it is best measured. For working purposes, it is sufficient to adopt a definition similar that suggested by Juster and Shay and developed here in Chapter 5—"financial inclusion" refers to a situation in which a consumer's access to desired financial products is an unrationed and an array of products are available in a reasonably competitive market. More simply, this definition more or less aligns with the traditional understanding that financial inclusion and access provide consumers with access to mainstream financial products on terms that may be different in degree but not in kind from the types of products used by middle-class households. Nevertheless, for ease of exposition we will use the conventional concepts of "unbanked" to describe those individuals who are outside the mainstream financial system and "alternative" products to describe the products they rely on, although we will return at the end of the chapter to the implications of recognizing a more nuanced approach that analyzes inclusion as more of a continuum.

B. Determinants of Financial Inclusion

Financial inclusion has unique demand and supply elements that differ from mainstream markets and consumers. Many public policy proposals fail to appreciate these underlying dynamics of the market and thus have often proven either ineffective or even counterproductive at addressing the problem.

Understanding the demand side of the financial inclusion question begins by recognizing that unbanked consumers seek access to financial services for the same reasons as all consumers—to reduce the transaction costs of engaging in every day commercial transactions (by having access to a bank account or some other transaction account), to exploit useful investment opportunities by shifting the time of purchases (especially of consumer durables, housing, and human capital investments), to use credit or savings to meet short-term imbalances between income and expenses, to save, and to smooth long-term consumption over their lifecycle.[7] Behavior that looks puzzling or irrational to financially established, upper-middle class, professional households might actually simply reflect different but rational choices made by lower-income consumers facing different constraints. As economist Jan Newton concluded in her study of "The Economic Rationality of the Poor" in 1977, "[P]oor people do perceive and act in accordance with marginal costs and returns… they make the most of what they have. They are… close to their optimum *given their circumstances*, which is the most we can say of anybody."[8] For these consumers who seek access to mainstream financial products but are unable to obtain it, constraints on financial inclusion are primarily a function of

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[7] *See* Theodore W. Schultz, *Nobel Lecture: The Economics of Being Poor*, 88 J. POL. ECON. 639, 649 (1980) (concluding "poor people are no less concerned about improving their lot and that of their children than those of us who have incomparably greater advantages. Nor are they any less competent in obtaining the maximum benefit from their limited resources"); *see also* Jan M. Newton, *Economic Rationality of the Poor*, 36 HUMAN ORGANIZATION 50, 58 (1977) (concluding that "low income consumers are rational satisfaction maximizers and that they share the basic values and goals of other, more affluent Americans").

[8] Newton, *supra* note 7, at 58 (emphasis added). Newton also notes that if researchers "assume that low income consumers are rational satisfaction maximizers and that they share the basic values and goals of other, more affluent Americans, a different research focus emerges. For if people seem to act less than optimally, the research question become these: what are their *resources* and what *constraints* impinge on them?" *Id.*

supply-side forces. Consequently, promoting financial inclusion should focus on the supply side of the market.

Some people remain outside the mainstream financial system do so by choice. They do so for a variety of reasons but in many cases they have negative subjective views of many financial providers either shaped by a general sense of distrust or adverse prior experiences with certain providers that have soured them. These consumers' preferences might be shaped by inaccurate perceptions or unrepresentative experiences and might be amenable to reconsideration through financial education programs, products, or providers that are better-designed for their individual needs. In other instances, use of alternative financial products is driven by less-benign motives, such as to conceal illegal activity or status, to hide purchases from one's spouse, or to avoid court-mandated garnishment or spousal support obligations. It is unlikely that preferences for these consumers are likely to change through greater use of financial education or policies designed to increase the supply of financial products.

The supply side of the financial inclusion challenge is determined by the cost and risk of providing financial services to traditionally underserved consumers. As discussed in Chapter 5, lower-income and higher-risk consumers can be costly to service because they can only qualify for small amounts of credit and the cost of providing products and services does not scale proportionately to the size of the credit extension. Lower-income consumers also tend to be less-profitable for banks because they hold smaller deposit balances and are less likely to use lending products such as credit cards, car financing, mortgages, and home equity loans that can produce additional revenue for the provider.

As the 2008 financial crisis illustrates, however, financial inclusion does not mean itself extending credit to a consumer who lacks the ability to repay it or offering financial products that are unsuitable for a consumer's personal circumstances can result in default and additional harm to a consumer, such as harm to credit score, loss of collateral, or even lawsuits and bankruptcy. Thus the challenge of financial inclusion should be recognized as a tradeoff between avoiding the extension of credit to uncreditworthy consumers on one hand and simultaneously avoiding incorrectly denying credit to creditworthy consumers on the other. "An excessive focus on avoiding Type I error leads to an undersupply of credit and a considerable underserved population. On the contrary, an excessive focus on avoiding Type II error leads to an oversupply of credit, causing a higher default rate as witnessed in the 2008 subprime mortgage crisis."[9]

II. Historical Causes and Consequences of Financial Exclusion

For most of history (predating the formation of the United States) credit use was viewed with suspicion, and government policy typically was intended to discourage access and use of credit by all but the wealthy. This skepticism was rooted in the notion that a fundamental distinction could be drawn between use of credit for business and commercial purposes (often characterized as "productive" borrowing) versus use of credit for consumer purposes (which was seen as purely for consumption) as well as the low esteem held by elites for the character and financial habits of the lower classes. Much of

[9] Hongchang Wang, Chunxiao Li, Bin Gu, Wei Min, *Does AI-Based Credit Scoring Improve Financial Inclusion? Evidence from Online Payday Lending* at 1 (ICIS 2019 Proceedings, 2019), *available in* https://aisel.aisnet.org/icis2019/blockchain_fintech/blockchain_fintech/20/#:~:text=Artificial%20intelligence%20(AI)%20has%20become,in%20the%20consumer%20finance%20industry.&text=Using%20data%20obtained%20from%20these,the%20quality%20of%20financial%20inclusion.

this skepticism was class-based; still other aspects of it were grounded in stereotypes about the believed capacity among some demographic groups to use financial services wisely and to resist the lure of immediate gratification.[10]

,Use of consumer credit was not particularly widespread during the Nineteenth Century, except in urban neighborhoods and agricultural areas where retailers provided credit to customers in a temporary bind and farmers as a bridge until the harvest arrived.[11] Installment lending to finance consumer durables, which emerged starting in 1807, was largely reserved for social and commercial elites. As Lendol Calder notes, early access to installment credit was limited to "men with good credit reputations, who had steady jobs, who were rooted in the community, and who were not subject to discrimination based on race and ethnicity."[12] As installment selling spread to cover new products and providers beginning in the late-19th century, it also "spread extensively among marginalized groups."[13] At that point, "retail installment credit ceased being a novelty and became something of a disgrace."[14] In the eyes of many elites, government officials, and consumer advocates of the era, "[T]he installment plan acquired a reputation for being the folly of the poor, the immigrant, and the allegedly math-impaired female."[15] Animosity toward those providing credit to previously-excluded consumers was often tinged with

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[10] *See* discussion in Newton, *supra* note 7, at 51 (describing prevailing stereotypes of the economic behavior of lower-income individuals).

[11] *See* NATIONAL COMMISSION ON CONSUMER FINANCE, CONSUMER CREDIT IN THE UNITED STATES 5 (1972) ("The image of the sturdy, self-reliant, resourceful pioneer who always paid cash for his staples and his tools may be the one imparted by some accounts of early colonial life, but it is not entirely accurate. Retail credit was available to farmers on a crop-to-crop basis. When they were short on cash, they did as many consumers do today—they traded their expectations of future income for goods and services from local merchants.").

[12] LENDOL CALDER, FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT 166 (2001).

[13] *Id.*

[14] *Id.*

[15] *Id.*

anti-semitism grounded in the hoary stereotype that the Jewish financiers who supposedly ran the American financial system and reaped obscene profits by seducing American workers into debt through exploiting their desire for instant gratification of their consumerist impulses.[16] Unfortunately, paternalistic attitudes unfortunately persist today among many commentators and government regulators who continue to support policies that restrict access to products desired by many consumers.

Demand for consumer credit changed dramatically in the late 19th and early 20th centuries as a result of the massive migration of Americans from farms to industrial cities. Urban life and the wage economy brought many Americans face-to-face with new challenges, including periodic unemployment, medical challenges, and in the 20th century a need for appliances necessary for city living, such as refrigerators, stoves, and washing machines. Although retailers would often be willing to extend credit to finance the purchase of appliances and other durables, consumers often also needed access to cash credit to pay for housing, medical care, or food, and to meet unexpected shocks to income or expenses, not just retail credit.

Alan Greenspan observed of the period from colonial times through the early 20th century, "access to credit for most people was quite limited, and where available at all, quite expensive."[17] He notes, "Only the economic elite were able to obtain personal loans from commercial banks, and then only on an accommodation basis because they were

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[16] For example, according to economic historian Louis Hyman, Henry Ford originally opposed the sale of Ford vehicles on installment credit, in part because he opposed inducing American workers to send money "back east to bankers" and particularly to "Jewish financiers" who supposedly ran the money markets. Ford believed that owing money to bankers would undermine the spirit of American independence by exposing them to the clutches of those lenders. *See* LOUIIS HYMAN, BORROW: THE AMERICAN WAY OF DEBT 53-55 (2012). Originally Ford offered to allow customers to buy cars on layaway (essentially a "save before you buy" program) but eventually relented to allowing credit sales.

[17] Federal Reserve Chairman Alan Greenspan, *Consumer Credit and Financial Modernization* (Oct 11, 1997), *available in* https://www.federalreserve.gov/boarddocs/speeches/1997/19971011.htm.

prominent merchants or landowners." Notably, "Commercial banks did not make consumer loans to the general public."[18] One commentator estimated in 1922 that only 7 of 100 persons had a bank account and only about 14 percent of the adult population could meet the requirements for underwriting and collateral to be able to borrow money from a bank. Needless to say, this 14 percent of the population was tilted toward the wealthy and well-connected and included very few working-class Americans.[19] This heightened demand by wage-earners for cash credit ran up against usury laws that had been inherited from the colonies, and before that, from England, which traditionally was the primary tool used to regulate credit use.

III. Credit Supply, Regulation, and Financial Exclusion

Until recently, usury laws were the primary tool used to regulate access to and use of consumer credit. Although supposedly intended to protect consumers, especially lower-income consumers, usury ceilings universally had the opposite effect: reducing access, limiting choice, and stifling competition. In many instances, this lack of access to legitimate credit provision pushed desperate working class families into the arms of illegal lenders and in the second half of the 20th century, mafia-controlled loan sharks. As discussed in chapters 4 and 5, it is economically impossible to make small loans profitably at low interest rates. As the NCCF observed, "Because the usury laws that the

[18] *Id.*; *see also* NCCF Report, *supra* note 3, at 46 (noting that in the early 20th century "commercial banks were unwilling to enter the consumer credit market, either because of their tradition of lending to commercial institutions or because consumer loans at permissible rates were unprofitable").
[19] J.A. Reichart, *The Loan Shark Still Flourishes*, 3 BROOKLYN CHAMBER OF COMMERCE BULLETIN 9 (July 1, 1922) (reprinted from *Forbes' Magazine*).

Colonies had inherited from England prevented the granting of cash loans at economically feasible rates, a legal instalment loan market was, in essence outlawed."[20]

As long as usury ceilings existed, consumers and lenders developed mechanisms to circumvent usury ceilings so that consumers could obtain access to the financial products that they needed. The roundabout and indirect means used resulted in deadweight loss to consumers and lenders, as they had to use more expensive and less efficient mechanisms to try to reach the desired level and variety of credit products.

There are typically three unintended consequences that result from the imposition of usury ceilings and often a fourth (that cuts across the other three).[21] These unintended consequences include: (1) Term repricing, (2) Product substitution, and (3) Rationing. In addition, market adjustments taken to circumvent usury ceilings also can have an adverse effect on market competition that is affected by the other behaviors. Finally, usury ceilings typically have regressive distributional consequences.

A. Usury Law and Financial Exclusion

1. Term Repricing

The first mechanism used by consumers and lenders to circumvent usury restrictions is the practice of "term repricing." As the NCCF found,[22] and has recently been reaffirmed,[23] the equilibrium price of financial services is established by fundamental supply and demand dynamics in a market, not by regulation. The NCCF found that where the market equilibrium rate of interest is below the statutory ceiling, it is

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[20] NCCF, *supra* note 3, at 5.
[21] *See* Todd J. Zywicki, *The Market for Information and Credit Card Regulation,* 28 BANKING AND FIN. SERV. POL'Y REPORT 13 (Vol. 1, 2009).
[22] NCCF Report, *supra* note 3, at 96-99.
[23] *See* Thomas W. Miller, Jr. and Todd J. Zywicki, *The Effects on Consumers from State-Level Regulation of the Payday Loan Market* (Apr. 30, 2020).

that price that prevails in the market and that prices do not rise to the statutory cap.[24] Where price controls are binding, however, interest rates settle at the statutory cap, which is set below the market equilibrium price. In such cases, if lenders cannot charge a market rate of interest, they can adjust other terms of the loan, such as requiring a downpayment (or a larger downpayment), demanding more aggressive default terms, requiring security for the loan, adjusting loan maturities, shortening the grace period before payment is due, reducing customer service or other benefits, and making other adjustments that are designed to implicitly raise prices to the market-clearing level.[25]

Because the costs of lending do not scale proportionally to loan size, lenders can circumvent APR ceilings by increasing the minimum size and lengthening the maturity of a loan.[26] But only lower risk and higher income borrowers can qualify for larger loans. Many consumers who are able to qualify at the larger minimum loan size effectively will be forced to borrow more than they would like for a longer period than desired, increase the risk of financial breakdown. The combination of longer loan maturities and larger loan size could also increase the total finance charges paid over the life of the loan.

A well-known example of usury rate circumvention through term repricing occurred when interest rate ceilings were binding during the 1970s and credit card issuers

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[24] NCCF Report, *supra* note 3, at 99.f

[25] *See* Orville C. Walker, Jr., & Richard F. Sauter, *Consumer Preferences for Alternative Retail Credit Terms: A Concept Test of the Effects of Consumer Legislation*, 11 J. OF MARKETING RESEARCH 70, 77 (1974); John J. Wheatley and Guy G. Gordon, *Regulating the Price of Consumer Credit*, 35 J. OF MARKETING 21, 23 (1971) ("Another serious limitation of the power of interest limitation laws or regulation is that none really controls the price of money or credit. Taken individually, they typically control only a portion of particular transactions—the portion which formally states an interest rate; however, in any such transaction, the true price of money or credit can often exceed the legal limit."). To limit loss rates, creditors in states with stricter usury ceilings typically pursue more aggressive collection efforts that elsewhere.

[26] *See* Thomas A. Durkin, Gregory Elliehausen, Min Hwang, *Rate Ceilings and the Distribution of Small Dollar Loans from Consumer Finance Companies: Results of a New Survey of Small Dollar Cash Lenders*, Working Paper (Dec. 4, 2014), *available in* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2533143; *see also* Paul F. Smith, *Pricing Policies on Consumer Loans at Commercial Banks*, 25 J. FIN. 517 (1970)

responded by assessing annual fees on cards.[27] Annual fees were regressive in their distributional effect, as most cards assessed the same annual fee regardless of income, borrowing habits, credit line, usage, risk profile, or other factors that would otherwise affect pricing decisions. Banks made credit cards or personal loans preferentially available to those consumers who also purchased other bank products whose prices were less-heavily regulated, which again benefited higher-income consumers.[28] Banks in states with stricter usury ceilings also charged higher service charges on demand deposit accounts and checking account overdrafts to offset their inability to make a normal rate of return on lending operations.[29] These various offsetting adjustments also hampered competition as annual fees operated as a tax on card-switching. Tying access to credit cards to purchase of additional bank services further reduced competition by raising the costs of changing providers.

As the NCCF observed, in imperfectly competitive markets, rate ceilings "may allow some better credit risks to pay less… but only at the expense of the higher risk borrowers who are excluded from the market."[30]

In fact, economists have concluded the primary beneficiaries of interest-rate controls were middle-class borrowers, not the poor. The application of usury ceilings enabled middle class borrowers to gain access to credit at below-market rates by making it uneconomical to lend to higher-risk borrowers, diverting lending capital from higher

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[27] Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAPMAN L. REV. 79 (2000).
[28] *See* A. CHARLENE SULLIVAN, EVIDENCE OF THE EFFECT OF RESTRICTIVE LOAN RATE CEILINGS ON PRICES OF CONSUMER FINANCIAL SERVICES (Credit Research Ctr. Working Paper No. 36, 1980).
[29] Zywicki, *Economics of Credit Cards*, *supra* note 27, at 160; SULLIVAN, *supra* note 28, at 20; RICHARD L. PETERSON & GREGORY FALLS, IMPACT OF A TEN PERCENT USURY CEILING: EMPIRICAL EVIDENCE 33 (Credit Research Ctr. Working Paper No. 40, 1981).
[30] NCCF Report, *supra* note 3, at 104.

risk to lower risk markets.[31] By limiting the ability to allocate credit through market prices, usury laws instead led to greater reliance on nonprice allocations, such as a prospective borrower's reputation or connections with a bank, both of which favored higher-income borrowers and created barriers to entry for new firms seeking to provide credit to those with less-established reputations and fewer connections at the bank (such as younger consumers). Non-price rationing also increases ability to engage in invidious discrimination against groups such as women and minorities who lacked those connections.[32] It is thus not surprising that political support for usury restrictions historically has come from middle class voters, not low-income and higher-risk groups.[33]

2. Product Substitution

Not all products have a sufficient number of terms that can be adjusted so as to make possible an attractive market for consumers. Annual fees, for example, will increase revenues to offset lost finance charges, but annual fees are an imperfect substitute for interest rates in pricing risk. Thus, without the ability to contract for a market rate of interest, many riskier borrowers were unable to gain access to credit cards, even if they were willing to pay an annual fee.

Higher-risk consumers are thus forced to substitute alternative products for their preferred choice. Eliminating the supply to consumers of a particular product (such as credit cards) does not eliminate the underlying consumer demand for credit. Through the 1970s, the most obvious form of product substitution was toward retail store credit because of he ease by which retailers could circumvent usury laws by bundling the

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[31] *See* Boyes, *supra* note **Error! Bookmark not defined.**.

[32] *See* Efraim Benmelech and Tobias J. Moskowitz. *The Political Economy of Financial Regulation: Evidence from U.S. State Usury Laws in the 19th Century*, 65 J. OF FINANCE 1029 (2010).

[33] *See* Boyes, *supra* note **Error! Bookmark not defined.**.

provision of credit with the sale of goods and marking up the price of the goods that they sold to offset their credit losses.[34] As discussed in Chapter 3, durable goods that provide a return over time emerged very early as products that frequently purchased on credit. As a result, retailers in states with binding usury ceilings could raise the price of those goods to offset credit losses with minimal loss of business.[35] In fact, retailers generally operated their credit operations at a loss, using them to subsidize purchases and build customer loyalty, and recouped those losses by raising the price of the goods they sold.[36] As a result, cash purchasers were forced to pay a higher price to subsidize credit purchasers who were able to pay below-market prices for the credit element of their transactions.[37] Moreover, retailers typically did not limit price increases to products usually sold on credit.[38] As the NCCF observed, "[F]orcing rates on sales credit below the level that would be set by the market may involve the forced transfer of a portion of the finance

[34] *See* NCCF Report, *supra* note 3, at 105-07; Gene C. Lynch, *Consumer Credit at Ten Percent Simple: The Arkansas Case*, 1968 ILLINOIS L. FORUM 592 (1968).
[35] *See* Wheatley & Gordon, *supra* note 25, at 24 ("Most retailers admitted to raising prices in direct response to the passage" of a 1968 Washington state initiative that reduce permissible interest rate charges for retailers and banks from 18% to 12%).
[36] *See* NATIONAL RETAIL MERCHANTS ASSOCIATION, ECONOMIC CHARACTERISTICS OF DEPARTMENT STORE CREDIT (1968) (study solicited by National Retail Merchants Association and conducted by Touche, Ross, Bailey & Smart); *see id.* at 50 ("It seems apparent that the average department store would enhance its profits by eliminating the credit function—if it could maintain the same sales volume. Not only would it make a greater profit, but it would be doing so on a much smaller investment, since discontinuing credit services would also eliminate the need for investing capital in accounts receivable."). *See also* NCCF REPORT, *supra* note, at 107, 145-46, and Table 7-18 (discussing National Retail Merchants Association study).
[37] A 1974 study found that of the various margins on which sellers can adjust to offset usury restrictions, low-income buyers were most strongly opposed to increases in the price of the goods purchased. *See* Orville C. Walker, Jr., & Richard F. Sauter, *Consumer Preferences for Alternative Retail Credit Terms: A Concept Test of the Effects of Consumer Legislation*, 11 J. OF MARKETING RESEARCH 70, 77 (1974). Higher-income consumers even more strongly opposed the use of retail price increases as a mechanism for circumventing interest-rate price controls than did lower-income consumers. *Id.* at 77-78. Survey evidence by Walker and Sauter found that 70-90% of purchases at department, appliance, and furniture stores between $400-$500 were made on credit. *Id.* at 73.
[38] Wheatley & Gordon, *supra* note 25, at 24; *id.* at 27 ("Cash customers… have received no benefits. They are probably paying higher prices because most retailers contacted had raised prices on *all* merchandise…"). Moreover, the Truth in Lending Act discourages charging different retail prices for cash and credit purchases; the price difference must be disclosed as part of the finance charge, which is likely to raise the interest rate above the rate cap.

charge into the cash prices of goods and services…. By providing subsidies, such laws also tend to discourage those who can obtain credit for using cash to buy goods."[39]

A 1979 study by Dunkelberg and DeMagistris illustrated the product substitution response to state usury ceilings.[40] They examined the composition of consumer credit in a state with a low maximum interest rate ceiling (Arkansas) with two states with higher ceilings (Wisconsin and Louisiana). They found that although the total amount of credit held by consumers in all the states was approximately equal, the composition among them differed. For example, 49% of all consumer credit outstanding in Arkansas was through retail providers (such as department stores) versus 29% in Wisconsin and Louisiana. Banks, finance companies, and credit unions provided only 51% of credit in Arkansas versus 67% in higher-cap states. Whereas 28% of consumers reported having been turned down for credit in Arkansas, only 12% reported the same in Louisiana. And Arkansas consumers were also more likely to say that retailers were the easiest place to get credit than residents of higher-cap states.[41]

Retailer's circumvention efforts benefited from preferential legal treatment. Under the judge-made "time price" legal doctrine, courts held that merchants could sell goods for different prices, a cash price and a higher "time" price.[42] Courts reasoned,

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[39] NCCF REPORT, *supra* note 3, at 106.

[40] William C. Dunkelberg and Robin DeMagistris, *Measuring the Impact of Credit Regulation on Consumer*, *in* THE REGULATION OF FINANCIAL INSTITUTIONS: CONFERENCE SERIES NO. 21, at p. 44 (1979).

[41] A 1981 study by Peterson and Falls compared borrowers in Arkansas with borrowers in states with less restrictive rate ceilings and similarly found that Arkansas consumers obtained the same amount of credit in total as those in other states, but they acquired a larger percentage of their credit from retailers. They also found that Arkansas consumers acquired a higher percentage of their credit from out-of-state sources, which suggests that many of them were crossing over to Texas to make credit purchases. RICHARD L. PETERSON & GREGORY D. FALLS, IMPACT OF A TEN PERCENT USURY CEILING: EMPIRICAL EVIDENCE (Purdue University Credit Research Center, Working Paper 14, 1981).

[42] *See* DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at 487.

"somewhat implausibly,"[43] that the "time" price was simply an offer to the buyer of a different price for the goods, and not a loan.[44] Thus, whereas those who offered cash credit (such as banks or personal finance companies) were limited by usury ceilings, under the "time price" fiction retailers could effectively circumvent limits by offering a "time price" that exceeded the cash price and which had an implicit, but unregulated, interest rate built in.[45]

Induced tying of transactions in goods together with the provision of credit to circumvent usury ceilings also dampened competition in both markets, to the detriment of consumers. Bundling sale of the goods together with credit also made prices less transparent for both items, making comparison shopping more difficult. The task of deciding between competing offers where one term offers a lower price and the other offers a lower APR could be challenging for most consumers. In making the joint purchase decision, consumers naturally focused on the cost and quality of the goods purchased more than the credit element, which dampened comparison shopping.[46] In states with higher legal rate ceilings, by contrast, lenders were more likely to include

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[43] *Id.*
[44] *Hogg v. Ruffner*, 66 U.S. 116 (1861).
[45] As Robert Shay observed of this distinction, "[T]he justification of the time-price doctrine has always escaped this economist's sense of logic." Robert P. Shay, *The Impact of the Uniform Consumer Credit Code Upon the Market for Consumer Installment Credit*, 33 LAW & CONTEMP. PROBS. 752, 757 (1968). Shay further noted that once installment loans gave way to revolving charge credit for retailers, the time price doctrine was effectively extended by statute in many states to formally permit retailers a higher interest rate than banks issuing credit cards. "The distinction between open-end sale credit, called revolving charge accounts, and open-end credit, called revolving loan credit, is that the credit contract is made with a seller in the first instance and with a lender in the second. Both may issue a credit card which an be used to purchase goods, but the seller in the first instance is given a higher rate ceiling than the second. This makes no sense, if we disregard the mandate of power politics." *Id.*
[46] NCCF REPORT, *supra* note 3, at 181.

information about finance charges in their advertising copy, which suggests greater competition for higher risk borrowers in those states.[47]

One major reason for the rapid growth of general purpose credit cards in the post-*Marquette* era (aside from the benefits it provided to consumers) was the opportunity that it provided retailers, especially smaller retailers, to outsource the cost and risk of operating credit operations onto banks.[48] In so doing, it also eliminated a competitive disadvantage for smaller companies seeking to compete against larger department store chains, which could more easily bear the expense and risk of providing its own in-house credit operations.[49]

More recent studies reveal this relationship between usury ceilings and product substitution. A 2017 study by Melzer and Schroeder examined the impact of state usury ceilings on automobile financing.[50] They found that in states where auto credit interest rate ceilings are binding, automobile dealers provided a higher percentage of car-loan financing, especially for riskier borrowers. They also found that the size of the loans made and the loan-to-value of loans made through dealers was higher than those by non-dealers. This suggests that auto dealers offset their inability to charge a market rate of interest by increasing the price of the car to compensate, especially for riskier

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[47] *See* Smith, *supra* note 26, at 520.

[48] In addition to the costliness of operating a credit operation and the general risk of nonpayment, retailers were also reluctant to us vigilant collection measures against delinquent borrowers for fear of alienating a customer, as a result, losses could be high. Outsourcing credit operations permits the retailer to gain the benefit of being able to sell goods to consumers on credit but to avoid the unpleasant task of collecting from delinquent borrowers.

[49] NATIONAL RETAIL MERCHANTS ASSOCIATION, *supra* note 36, at 51-52.

[50] Brian Melzer and Aaron Schroeder, *Loan Contracting in the Presence of Usury Limits: Evidence from Automobile Leasing*, Consumer Financial Protection Bureau Office of Research Working Paper No. 2017-02 (March 2017).

borrowers.[51] Because banks and other non-dealer lenders lack this opportunity to pack financing costs into the price of the car, they are unable to compete for many customers, especially riskier borrowers. Lacking effective competition from other credit providers such as banks or credit unions that could not make loans to higher-risk borrowers at the permitted rate, this dynamic also can create market power for dealers, which can be exploited by marking up the price of the vehicle still further.

But product substitution as a result of interest rate ceilings was not limited to greater use of retail credit. While retailers filled the gap for purchase of goods, they did not provide cash loans. To meet that need, consumers turned to alternative products such as pawnbrokers, which Peterson and Falls found were "far more prevalent in the Arkansas market" than in states with less restrictive usury ceilings.[52] Pawn shops often operated under distinct rules that permitted higher interest rates than other types of loans and could circumvent even those limits by discounting the value they offered for the goods pledged. Recent research has found that similar product effects persist today. For example, regulatory bans on payday loans prompt payday loan customers to shift to greater use of pawn shops,[53] overdraft protection,[54] or alternatives such as bounced

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[51] Dealers can also circumvent usury restrictions by reducing the trade-in value that they offer to a prospective buyer, which would be functionally equivalent to a price increase on the end purchase. *See* Wheatley and Gordon, *supra* note 25, at 24.

[52] *See* PETERSON & FALLS, *supra* note, at 16 (comparing Arkansas with Wisconsin, Illinois, and Louisiana); *see also* Donna Vandenbrink, *The Effects of Usury Ceilings*, ECONOMIC PERSPECTIVES 44, 50 (Federal Reserve Bank of Chicago (1982). The impact in Arkansas was not just felt with credit cards. As economist Richard Rahn testified in Congress in 1983, "Arkansas' 10-percent ceiling for instance, caused every personal loan company to leave the state when interest rates rose after 1977." Statement of Richard W. Rahn on "The Credit Deregulation and Availability Act of 1983," Hearing Before the United Senate Committee on Banking, Housing, and Urban Affairs (Apr. 12, 1983) at 56.

[53] *See* Neil Bhutta, Jacob Goldin, and Tatiana Homonoff, *Consumer Borrowing After Payday Loan Bans*, 59 J. L. & ECON. 225 (2016).

[54] *See* Donald Morgan, Michael Strain, and Ihab Seblani, *How Payday Credit Access Affects Overdrafts and Other Outcomes*, 44 J. OF MONEY, CREDIT, AND BANKING 519 (2012);Brian T. Melzer and Donald P.

checks and late bill payments[55]. Similarly, as discussed below, reduced access to credit cards by higher-risk consumers as a result of the Credit CARD Act of 2009 pushed many of those consumers to greater reliance on personal finance installment loans.[56]

3. Rationing and Illegal Lending

A third effect of usury regulation is rationing. Term repricing and product substitution adjustments will enable many consumers to still meet their demand for credit, albeit at higher prices and inconvenience than would otherwise prevail. Nevertheless, if the regulatory regime is sufficiently restrictive to limit the supply of legal credit available, some consumers will experience unmet demand for credit. Rationing of credit can occur either by lending less to all or most borrowers (by reducing available credit lines) or eliminating or reducing lending to higher-risk borrowers.

Limiting the supply of credit does not eliminate the demand—which sometimes has been satisfied by illegal lending (i.e., "loan sharks"). As the NCCF noted in 1972, although usury ceilings eliminated supply, "Since the need for small cash credit nonetheless existed, a flourishing illegal market developed."[57] As the NCCF observed, "Before development of licensed consumer finance companies between 1910 and 1930, the loan shark was probably the most common source of credit for the wage earner. Loan

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Morgan, *Competition and Adverse Selection in the Small-Dollar Loan Market: Overdraft versus Payday Credit*, Federal Reserve Bank of New York Staff Report No. 391 (2009).

[55] *See* Jonathan Zinman, *Restricting Consumer Credit Access: Household Survey Evidence on Effects Around the Oregon Rate Cap*, 34 J. OF BANKING AND FIN, 546 (2010).

[56] *See* Gregory S. Elliehausen and Simona M. Hannon, *The Credit Card Act and Consumer Finance Company Lending*, 34 J. OF FIN. INTERMEDIATION 109 (2018).

[57] NCCF Report, *supra* note 3, at 5.

sharking prospered because legitimate lenders could not profitably lend to consumer borrowers under the low usury law ceilings."[58]

Former Federal Reserve Chairman Alan Greenspan observed, "One study estimated that in American cities with populations of over 25,000, about one family in five was the victim of loan sharks."[59] Greenspan described the plight of these borrowers in thrall to illegal lenders for "burdensome payments" as a condition of "virtual serfdom."[60] It is estimated that, in 1911, 35 percent of New York City's employees owed money to illegal lenders.[61] Not all illegal lenders were violent loan sharks, however; many simply lent at rates that exceeded statutory rate ceilings and were otherwise open and notorious. In Chicago in 1916, for example, there were 139 active loan offices, all of which were illegal.[62]

Later in the 20th century, however, loan sharking operations became the province of organized crime, which enforced its racket by threats of physical violence.[63] For obvious reasons, the size of the illegal criminal loan shark racket has been difficult to

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[58] *Id.*; *see also* J.A. Reichart, *The Loan Shark Still Flourishes*, 3 BROOKLYN CHAMBER OF COMMERCE BULLETIN 9, 15 (July 1, 1922) (reprinted from *Forbes' Magazine*) ("The intent [of these laws], of course was good, but the effect was to more firmly entrench the loan shark. The borrower had to have the money, but could not get it under the law. So he went about the matter clandestinely and was charged an even higher rate than he would have had to pay were there no anti-loan shark law in the state, because of the extra hazard the lawn shark incurred in transgressing the law.")

[59] Federal Reserve Chairman Alan Greenspan, *Consumer Credit and Financial Modernization* (Oct 11, 1997), *available in* https://www.federalreserve.gov/boarddocs/speeches/1997/19971011.htm.

[60] *Id.*; *see also* NCCF Report, *supra* note 3, at 46 (from 1880 to 1920 "urban America became the illegal lender's paradise").

[61] *See* ROWENA OLEGARIO, THE ENGINE OF ENTERPRISE: CREDIT IN AMERICA 108 (2016).

[62] Irving S. MICHAELMAN, CONSUMER FINANCE: A CASE HISTORY IN AMERICAN BUSINESS 110 (1966)

[63] *See* RONALD GOLDSTOCK & DAN T. COENEN, PERSPECTIVES ON THE INVESTIGATION AND PROSECUTION OF ORGANIZED CRIME: EXTORTIONATE AND USURIOUS CREDIT TRANSACTIONS: BACKGROUND MATERIALS (Cornell Institute on Organized Crime, 1978). Violent loan sharks tied to organized crime became more prominent in the second half of the 20th century.

measure.[64] One estimate in 1969 by an FBI expert on organized crime claimed that the size of the mafia-controlled illegal loan shark market in the United States was about $10 billion, equivalent to approximately $69 billion in 2020 dollars, adjusted for inflation.[65] For purposes of comparison, that estimated market size is about twice the size of the estimated $32 billion payday loan market (storefront and online combined) in the United States today.[66] A 1968 United States Senate report concluded that although "no reliable estimates exist of the gross revenue that racketeers derive from organized loan sharking" it estimated that loan sharking was organized crime's second largest revenue source at that time, trailing only illegal gambling operations.[67] Paul Samuelson, the first American to be awarded the Nobel Prize in Economics, testified before the Massachusetts State Legislature in 1969 in arguing for the elimination of usury ceilings on consumer credit:

> The concern for the consumer and for the less affluent is well taken. But often it has been expressed in a form that has done the consumer more harm than good. For fifty years the Russell Sage Foundation and others have demonstrated that setting too low ceilings on small loan interest rates will result in drying up legitimate funds to the poor who need it most and will send them into the hands of the illegal loan sharks. History is replete with cases where loan sharks have lobbied in legislatures for unrealistic minimum rates, knowing that such meaningless ceilings would permit them to charge much higher rates.[68]

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[64] *See* Todd J. Zywicki, *The Sanders-AOC Protection for Loan Sharks Act*, REALCLEARPOLITICS.COM (June 9, 2019), https://www.realclearpolitics.com/articles/2019/06/02/the_sanders-aoc_protection_for_loan_sharks_act_140472.html.

[65] RALPH SALERNO, THE CRIME CONFEDERATION: COSA NOSTRA AND ALLIED OPERATIONS IN ORGANIZED CRIME (1969).

[66] *See* Eric Wilson and Eva Wolkowitz, *2017 Financial Underserved Market Size Study*, CENTER FOR FINANCIAL SERVICES INNOVATION (Dec. 2017), https://s3.amazonaws.com/cfsi-innovation-files-2018/wp-content/uploads/2017/04/27001546/2017-Market-Size-Report_FINAL_4.pdf.

[67] *See* United States Senate, Committee on Government Operations, Subcommittee on Legal and Monetary Affairs, "Federal Effort Against Organized Crime: Report of Agency Operations" (June 1968).

[68] Statement by Dr. Paul A. Samuelson Before the Committee of the Judiciary Of the General Court of Massachusetts in Support of the Uniform Consumer Credit Code, *reprinted in* STATEMENTS OF FORMER SENATOR PAUL DOUGLAS AND PROFESSOR PAUL SAMUELSON ON THE UNIFORM CONSUMER CREDIT CODE 7, 8 (National Conference of Commissioners on Uniform State Laws, Jan. 29, 1969).

This connection between unreasonably low interest rates, the elimination of legal small-dollar lending, and the presence of loan sharks was captured in a 1964 statement by New York Senator-elect Robert F. Kennedy submitted to the New York State Legislative Committee investigating organized crime, which urged "altering the state laws on usury so an insolvent person who needs money for legitimate purposes might borrow it at rates that were not exorbitant."[69] By 1968 the loan shark problem was so notorious in so many cities that Richard Nixon highlighted the issue in his speech accepting the Republican Party nomination for President that year and even rebroadcast his pledge to attack the loan-shark problem in television ads.[70] There is little reason based on economic theory or historical evidence to believe eliminating the supply of legal credit will eliminate the demand.

B. The Elimination of Usury Laws and Growing Financial Inclusion

1. Historical Efforts at Greater Financial Inclusion

Recurrent problems of usury laws including evasions, high cash prices for goods purchased on credit, lack of transparency, regressive term substitution, rationing, and illegal lending have periodically prompted actions by reformers. The typical initial response was to enforce usury ceilings more aggressively. But that response often just created more fertile ground for loan sharks to operate. Eventually the failure of efforts to

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[69] *Inquiry is Begun on Loan Sharks: Underworld's Investment in Racket is Put at Billion*, NEW YORK TIMES (Dec. 2, 1964).

[70] *See* Walter D. Malcolm and John J. Curtin, Jr., *The Federal Attack on the Loan Shark Problem*, 33 LAW & CONTEMP. PROBLEMS 765, 765 (1968).

suppress the market became apparent, producing an acceptance of the need to amend the law to allow legal small-dollar lenders to operate.[71]

Early efforts at increasing access to consumer credit were through the authorization of "semi-philanthropic lending institutions known as remedial loan societies."[72] These institutions were permitted to charge higher rates than other non-philanthropic lenders but they were still strictly limited in the rates they could charge. But small-dollar loans have substantial risk of loss of repayment and are costly to make in terms of the size of the loan relative to the fixed costs, even for a non-profit organization. Thus, while remedial loan societies were permitted to charge a higher price, it still wasn't high enough—beneficial loan societies fell far short of being able to meet the all the demand from small loans serving all the needs of consumers.[73] Moreover, they were still limited to lending to relatively credit-worthy borrowers, thus did little to reach minorities, immigrants, and many other working class households. Credit unions were first authorized in 1909 and Morris Plan banks emerged in 1910.[74] While these institutions also helped to extend needed credit to wage-earners, they played a modest role in meaningfully increasing financial access for many Americans. Credit unions, for example, "were typically organized around workplaces or among workers in a particular

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[71] DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at 489.
[72] DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at 489.
[73] *See Current Legislation: The Uniform Small Loan Law*, 23 COLUM. L. REV. 484 (1923) ("Philanthropic lending institutions may meet the need of a small number of needy borrowers, but the need for small loans is too great to be adequately met in this way, even if charity be considered an effective cure for an economic evil."); Elisabeth Anderson, *Experts, Ideas, and Policy Change: The Russell Sage Foundation and Small Loan Reform, 1909-1941*, 37 THEORY AND SOCIETY 271, 291 (2008).
[74] *See* DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at 490; *see also* James R. Barth and Yanfei Sun, *Industrial Banks: Challenging the Traditional Separation of Commerce and Banking*, 77 Q. REV. ECON. AND FIN. 220 (2020).

employment sector, [thus] they failed to meet the needs of the poorest borrowers, those who were unemployed or marginally employed."[75]

The first wave of reform was spearheaded by the Russell Sage Foundation in the 1910s and culminated in the Uniform Small Loan Law ("USSL"), which created a clear regulatory framework for small-dollar loans. The first edition of the USSL was published in 1916 and went through successive drafts through a seventh edition published in 1942.[76] At the heart of the Russell Sage Foundation's reforms was a proposal to increase the permissible interest rate ceiling on small-dollar loans so as to make it feasible to provide credit to wage-earners legally and to still earn a reasonable rate of return on capital. By making legal small-dollar lending economically feasible, the USSL brought small-dollar lending out of the shadows and into the regulated market which, among other benefits, enabled more effective regulation of abusive collection activity.[77] Moreover, once legal, the market also became more transparent and competitive.[78] As noted by Samuelson above, the reforms advanced by the Russell Sage Foundation were resisted by many of the existing illegal lenders, which were prospering under the illegal lending regime.[79] It was estimated that prior to the adoption of small-loan legislation, the interest rate on

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[75] Anderson, *supra* note 73, *see also Current Legislation*, *supra* note 73, at 484.
[76] *See* George G. Bogert, *The Future of Small Loan Legislation*, 12 UNIV. OF CHICAGO L. REV. 1 (1944).
[77] *See* DAVID H. ROGERS, CONSUMER BANKING IN NEW YORK (1974); Benjamin S. Horack, *A Survey of the General Usury Laws*, LAW AND CONTEMPORARY PROBLEMS (1941); *Current Legislation*, *supra* note 73, at 487 ("[U]nder the [USSL] the business of money lending has been brought into the light, has changed from an underhanded, semi-legal enterprise which the world stigmatized as loan shark to that of an honorable, commercial venture, while at the same time the interest charges to the borrowing public have been lowered from the former exorbitant amounts of from one hundred per cent to one thousand per cent to a comparatively small rate of forty-two per cent per annum.").
[78] *See* Bruce G. Carruthers, Timonty W. Guinnane, and Yoonseok Lee, *Bringing "Honest Capital" to Poor Borrowers: The Passage of the U.S. Uniform Small Loan Law, 1907-1930*, 42 J. INTERDISCIPLINARY HISTORY 393 (2012). For example, even though Morris Plan banks provided needed credit to workers, the Russell Sage Foundation was a critic of those lenders because of their non-transparent pricing. *Id.*
[79] Elisabeth Anderson, *Experts, Ideas, and Policy Change: The Russell Sage Foundation and Small Loan Reform, 1909-1941*, 37 THEORY AND SOCIETY 271, 285 (2008).

illegal loans was approximately 10 to 20 percent per month and annual rates of 500 to 1000 percent or even higher were found.[80] Still, desperate families needed help to deal with life's setbacks and turned to these lenders for lack of any alternative. Moreover, because borrowers needed the money, they were reluctant to complain to authorities and jeopardizing a future source of credit.

The illegal lenders' crusade against raising prevailing interest-rate ceilings was indirectly supported by many advocacy groups, religious leaders, and public officials, who persisted in their demands for unrealistically low usury ceilings. One headline portrayed the Russell Sage Foundation as a Wall Street front, "Wall Street Warns Colorado She Must Triple Interest Rate: Rockefeller and Sage Foundations Send Envoy."[81] Still, despite this "Bootleggers and Baptists"[82] coalition of opposition to legalized higher-cost lending, the indefatigable education and activism efforts of the Russell Sage Foundation's Arthur Ham resulted in the gradual adoption of the USSL throughout the country.[83] By 1932, twenty-five states had adopted a version of the USSL and by the 1960 almost all states had done so. In states where the USSL was adopted illegal lending largely disappeared.

Some states, however, adopted parts of the USSL, but not the higher interest rate ceilings. Other states adopted the USSL's higher interest rate ceilings but over time

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[80] *Id.*
[81] Anderson, *supra* note, at 284 (quoting *The Denver Post*, Feb. 14, 1919). Sage himself had been a financier known for his "ruthless lending practices." His widow took the lead in turning the Russell Sage Foundation into a leader for poverty relief, including promotion of small-loan laws.
[82] *See* Bruce Yandle, *Baptists and Bootleggers: The Education of a Regulatory Economist* cite
[83] *See* ARTHUR HAM, THE CAMPAIGN AGAINST THE LOAN SHARK (192); *see also* LOUIS N. ROBINSON AND ROLF NUGENT, THE REGULATION OF THE SMALL LOAN BUSINESS (1935); Rolf Nugent, *Three Experiments with Small Loan Interest Rates*, HARV. BUS. REV. (1933); Rolf Nugent, *The Loan Shark Problem*, LAW AND CONTEMPORARY PROBLEMS (1941).

reduced permitted charges.[84] In response to the Great Depression, which was seen at the time as having been precipitated in part by excessive use of consumer credit,[85] many states reinstated lower usury ceilings and added a new requirement that before a new small-loan provider should be licensed under the USSL the applicant would be required to demonstrate that doing so would serve the "convenience and advantage" of the community. This erected a government-enforced barrier to entry and reduced competition.[86] The original foundation of the "convenience and advantage" restriction on entry was the belief that crystallized during the New Deal that there were economies of scale in consumer lending and there were that minimum economies of scale necessary to remain financially stable and to engage in responsible lending practices. Excessive competition, it was thought, would result in a market with too many competitors of inefficiently small size that would then compete excessively for business and lend excessively to higher-risk consumers. As a result, small-dollar lenders should be regulated like public utilities to ensure adequate economies of scale and returns on capital (similar requirements are common in areas regulated as public utilities, such as hospitals).[87] The NCCF reviewed this claim and found no support for the hypothesis that there are significant economies of scale in small-dollar lending operations but that those

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[84] *See* F.B. Hubachek, *The Development of Regulatory Small Loan Laws*, 8 L. & CONTEMPORARY PROBLEMS 108 (1941).
[85] *See* Charles E. Persons, *Credit Expansion, 1920 to 1929, and its Lessons*, 45 Q. J. ECON. 94 (1930); *see also* Martha L. Olney, *Avoiding Default: The Role of Credit in theConsumption Collapse of 1930*, 114 Q. J. ECON. 319 (1999); Barry Eichengreen and Kris Mitchener, *The Great Depression as a Credit Boom Gone Wrong*, BAK FOR INTERNATIONAL SETTLEMENTS BIS WORKING PAPERS No. 137 (Sept. 2003).
[86] *Id.*; NCCF Report, *supra* note 3, at 47 (noting the "convenience and advantage" requirement was added to the fifth draft of the Uniform Small Loan Law).
[87] *See* NCCF, *supra* note 3, at 102; Edwin M. Stockes, *Convenience and Advantage in Small Loan Licensing, A Workable Standard*, 2 BOSTON COLLEGE INDUSTRIAL AND COMMERCIAL LAW REVIEW 93, 94 (1960) (noting that the "convenience and advantage" requirement was added in the fifth draft of the Uniform Small Loan Law in 1932 because "experience had shown" that "the public interest was not well served where competition was too severe").

requirements operated as an anti-competitive barrier to entry.[88] The NCCF also rejected the idea that consumers benefited from taking a public utility approach to the regulation of small-loan companies. Instead, it concluded that eliminating regulatory barriers to entry and competition would create incentives to provide credit at market-clearing prices to all consumers: "The profit motive should be strong enough in our economy to assure that credit grantors will try to make as much credit available as possible at 'fair' prices and that if one creditor's 'blind spot' keeps him from extending credit to a creditworthy individual, another creditor will probably jump at the chance."[89] As the NCCF further noted, in a competitive market, there is no basis to judge whether "all have obtained 'all' the credit of the 'type they wanted, that they were 'entitled' to, at a 'fair' rate." The Commission continued, "Nor can [the Commission] say that the price of hamburger or shoes was 'fair' at any given time, or that more of either might be better. In almost all instances in our economic system, we look toward a marketplace. If sufficient alternative sources compete for patronage, it is assumed that the price and supply are 'fair', because they are set by free competitive forces. The Commission perceives no reason to assume that—in general—competition will not have the same result in the consumer credit area."[90]

The linchpin of the NCCF's approach to access and inclusion was the promotion of competition and the elimination of usury ceilings and other regulatory barriers that interfered with the natural flow of market forces that would serve all consumers at

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[88] *See* NCCF, *supra* note 3, at 114.
[89] NCCF, *supra* note 3, at 2.
[90] NCCF, *supra* note 3, at 3.

competitively-set prices. Marginal consumers were those most likely to benefit from elimination of uncompetitive approaches to lending.

The NCCF went so far as to suggest that if the states refused to reform their laws and regulations, federal preemption might be appropriate to protect marginal consumers:

> The Commission recommends a consistent approach. If there is to be free access, open competition, and elimination of harmful or inappropriate practices, then *inhibiting* rate ceilings should be reviewed and revised to allow competitive forces to operate.
>
> Finally, the Commission fails to see why every citizen of the United States is not entitled to qualify for participation in some part of the credit system herein advocated. It can find no validity in the proposition that when the legislature of a particular state refuses to move away from anachronistic notions, its citizens should suffer deprivation of credit afforded others of equal standing. Accordingly, the Commission urges as its first choice the adoption of state laws designed both to assure fair treatment of all consumers and to give all credit grantors equal opportunity to compete. Failing this, the Commission's second choice is to urge Federal legislation to accomplish this goal.[91]

2. Deregulation of Credit Card Interest Rates the Effect on Financial Inclusion

The NCCF's hypothesis that competition would promote financial inclusion was quickly tested and confirmed within just a few years when the United States Supreme Court decided the monumental case of *Marquette National Bank v. First of Omaha Service Corp.*[92] In a unanimous decision authored by Justice William Brennan, the Supreme Court held that under the National Bank Act the interest rates that federally-chartered banks could legally charge would be established by the regulatory regime of the state in which the bank was located, rather than the state where the transaction in question

[91] NCCF, *supra* note 3, at 4.
[92] 439 U.S. 299 (1978).

occurred. This holding was particularly important for credit card issuers, who by that time had started to market their credit card products across state lines.[93]

The case arose from a challenge by Marquette National Bank of Minnesota to the entry of First Omaha Service Corporation, a Nebraska-based institution, into Marquette's traditional territory. Both institutions offered cards under the BankAmericard brand (now known as Visa). As a Minnesota-based bank, Marquette was governed by the state's 12 percent usury ceiling whereas First Omaha was subject to Nebraska's higher permitted ceiling of 18 percent on the first $999.99 of unpaid balances and 12 percent on balances above this amount. More significant, however, was that to offset Minnesota's below-market rate ceiling, Marquette charged an annual fee (euphemistically termed a "privilege fee" or "membership fee") of $10, formerly $15.[94] Adjusted for inflation, a $15 annual fee in 1978, the year of the *Marquette* decision, is equivalent to $58.99 today. Because First of Omaha was governed by Nebraska's higher rate ceiling, by contrast, it was able to offer its without membership fee for consumers and to charge an interest rate that more accurately reflected relative risk. Rising interest rates and inflation during the 1970s pushed up credit card interest rates as well, putting increasing pressure on consumers in states with lower interest rate ceilings.

Marquette complained that First Omaha had an unfair competitive advantage because its no-annual fee card was more attractive to consumers than the card terms Marquette realistically could offer.[95] Indeed, Marquette's lawyer admitted that one

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[93] This discussion draws from Zywicki, *The Economics of Credit Cards*, *supra* note 27.
[94] Minnesota's statutory scheme permitted charging an annual fee of up to $15. 439 U.S. at 303.
[95] 439 U.S. at 304 ("Marquette claimed to be losing customers to Omaha Bank because, unlike the Nebraska bank, Marquette was forced by the low rate of interest permissible under Minnesota law to charge a $10 annual fee for the use of its credit cards." The record suggests that Marquette's card program was

purpose of Minnesota's legal regime was to protect state banks from competition, independent of any adverse impact on Minnesota consumers.[96] The Court recognized that any alternative rule, such as applying the law of the state in which a particular transaction occurred, would be unworkable. Although Minnesota consumers would most often use their cards to transact with Minnesota merchants, the BankAmericard system was created to enable consumers "to purchase goods and services from participating merchants and obtain cash advances from participating banks throughout the United States and the world."[97] As the Court noted, "Minnesota residents can thus use their Omaha Bank BankAmericards to purchase services in the state of New York or mail-order goods from the State of Michigan. If the location of the bank were to depend on the whereabouts of each credit-card transaction, the meaning of the term 'located' would be so stretched as to throw into confusion the complex system of modern interstate banking. A national bank could never be certain whether its contacts with residents of foreign States were sufficient to alter its location for purposes of §85 [of the National Bank Act]."[98] As Americans became more mobile and the volume of interstate transactions increased as a result of improvements in communications technology, the costs of a state-by-state regulatory system became increasingly apparent.

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acquired from an earlier institution that charged a $15 annual fee.) In response to this argument First of Omaha's lawyer Robert Bork rejoined that if that was the problem, Marquette "would have done better to take their case to an advertising agency instead of a law firm." Transcript of Oral Argument, *Minnesota and Marquette National Bank of Minneapolis v. First of Omaha Service Corporation*, Case Nos. 77-1258, 77-1265 (Oct. 31, 1978) at 34.

[96] *See* Transcript of Oral Argument, *Minnesota and Marquette National Bank of Minneapolis v. First of Omaha Service Corporation*, Case Nos. 77-1258, 77-1265 (Oct. 31, 1978) at 25 (argument of John Troyer on behalf of Marquette National Bank) ("If you're going to allow a Nebraska bank to come in here to the state of Minnesota and by offering the card free draw off, and in effect, to ruin Marquette's bank card program, what's to stop it from going to some other state and doing the same thing? No local, national, or state bank will be safe from the predatory practices, then, of out of state national banks located in the state permitting the higher interest rate.")

[97] 439 U.S. at 312 (quoting Stipulation of Facts, App. 91a).

[98] 439 U.S. at 312.

As *Marquette* illustrates, once all of the unintended consequences are considered, usury regulations had a strongly regressive effect and an adverse effect on financial inclusion. First, by establishing such a low permissible rate of finance charge, the presence of binding usury ceilings ensured that only the very lowest risk consumers would gain access to credit cards, whereas credit cards could be made available to many more consumers at higher rates. Second, even when consumers were fortunate enough to gain access to a credit card, credit lines were highly limited. For example, during the 1970s Arkansas law capped the permissible interest rate on the typical credit card issued by a state institution at 8 percent, far below the otherwise prevailing market rate. As a result, only 10 percent of credit card applications were approved and the available credit line was often limited to only $800.[99] In fact, as underlying interest rates rose in the economy during the 1970s prior to the *Marquette* decision, the number of credit cards in circulation actually *fell* as interest rates increasing collided with usury ceilings. Lower-income consumers, of course, were those most likely to be rationed out of access to credit cards during this time.[100] Consumers in Minnesota who were unable to gain adequate access to credit cards were forced to substitute to alternative types of credit.[101]

The Supreme Court's decision in *Marquette* held the maximum interest rate that could be charged on credit cards would be the home state of the issuing bank. In that

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[99] *See* DAVID S. EVANS AND RICHARD J. SCHMALENSEE, THE ECONOMICS OF THE PAYMENT CARD INDUSTRY 59 (1993).
[100] *See* Zywicki, *Economics of Credit Cards*, *supra* note 27, at 162; *see also* Daniel J. Villegas, *The Impact of Usury Ceilings on Consumer Credit*, 56 S. ECON. J. 126, 140 (1989); Glenn B. Canner and James T. Fergus, *The Economic Effects of Proposed Ceilings on Credit Card Interest Rates*, 73 FED. RES. BULL. 1 (1987).
[101] The state's small loan law permitted "33 [percent] for up to $300, 18 percent for $300 to $600, and 15 percent up to $1,200 was the outside limit." Transcript of Oral Argument, *Minnesota and Marquette National Bank of Minneapolis v. First of Omaha Service Corporation*, Case Nos. 77-1258, 77-1265 (Oct. 31, 1978) at 14.

particular case, the winner was Nebraska. But it soon became evident that the big winner over the coming decades would be South Dakota and Delaware, states with no interest rate ceilings on credit cards. As was the case in the competition between Marquette and First of Omaha for credit card business, banks headquartered in low-ceiling states such as Arkansas could offer lower interest rates—but with high annual fees and other distasteful terms. Indeed, even issuers based in South Dakota could offer a card with a lower interest rate and high annual fee if they wanted to—but the reality was thatarquette complained that First of Omaha was "draw[ing] off" its customers, not the other way around. This preference for a no annual fee card is not surprising, especially for lower-income consumers or those who do not revolve balances, which amounts to roughly half of cardholding households. Thus, it is not surprising that in the wake of *Marquette*, no annual fee cards quickly came to dominate the market and today are the market standard, except for cards that provide extensive rewards programs such as cards linked to airline frequent flyer rewards.

The effect of *Marquette* for consumers was profound, especially for lower-income and higher-risk borrowers. First, by removing price controls that had prevented many consumers from acquiring cards, it enabled more accurate risk-based pricing of credit offers that could include riskier borrowers in the system. Second, by indirectly eliminating annual fees (which had largely served to circumvent usury ceilings), lower-income consumers could more easily afford to have a card. Indeed, today many consumers hold multiple cards at any given time, effectively increasing their available credit limits (by stacking the credit lines) and fueling competition among card issuers for customer loyalty..[102] Third, deregulation eliminated state usury ceilings that arguably had created price "focal points" that could facilitate implicit collusion among competitors in local markets. Combined with barriers to entry in local banking markets focal-point pricing also tended to dampen competitive forces.[103] *Marquette* spurred entry and competition in previously-protected markets, enabling greater product variety in card features and better matching of products with consumer preferences, including the introduction of cards co-branded with various retail companies and airlines, cash back rewards, or cards co-branded with various non-profit organizations or charities.

Figure 10-1 illustrates the dramatic transformation of the American consumer economy in the aftermath of *Marquette*. In 1970, only 16 percent of American households had a bank-type credit card compared to 45 percent that had a retail store card.[104] By 2001, holders of bank-type cards had risen to 73 percent of households. Among households in the lowest income quintile, the number increased from a mere 2 percent of households in 1970 to 38 percent by 2001. Among the second-lowest quintile households the trend was similar: just 9 percent of those households had a bank-type credit card in 1970 but 65 percent did by 2001.[105]

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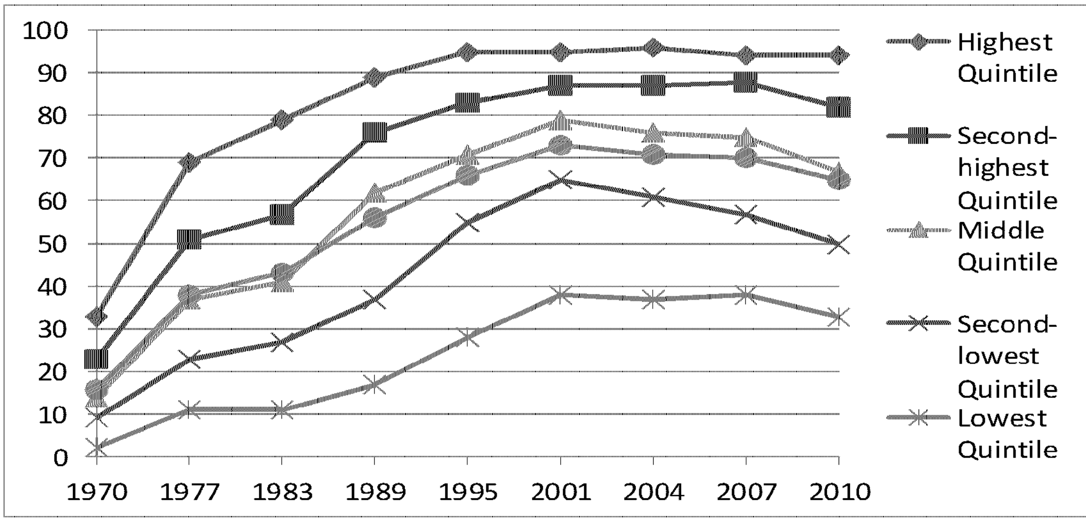
[102] The average American holds approximately four credit cards today. *See* Matt Tatham, *A Look at U.S. Consumer Credit Debt*, EXPERIAN.COM (Nov. 4, 2019), *available in* https://www.experian.com/blogs/ask-experian/state-of-credit-cards/. The average number of credit cards held by households dipped substantially following the Great Recession and enactment of the Credit CARD Act of 2009 and as of 2016 still had not recovered. *See* Joe Resendiz, *Average Number of Credit Cards Per Person: 2019 Card Ownership Statistics*, VALUEPENGUIN.COM (June 13, 2020), *available in* https://www.valuepenguin.com/average-number-credit-cards-per-person.

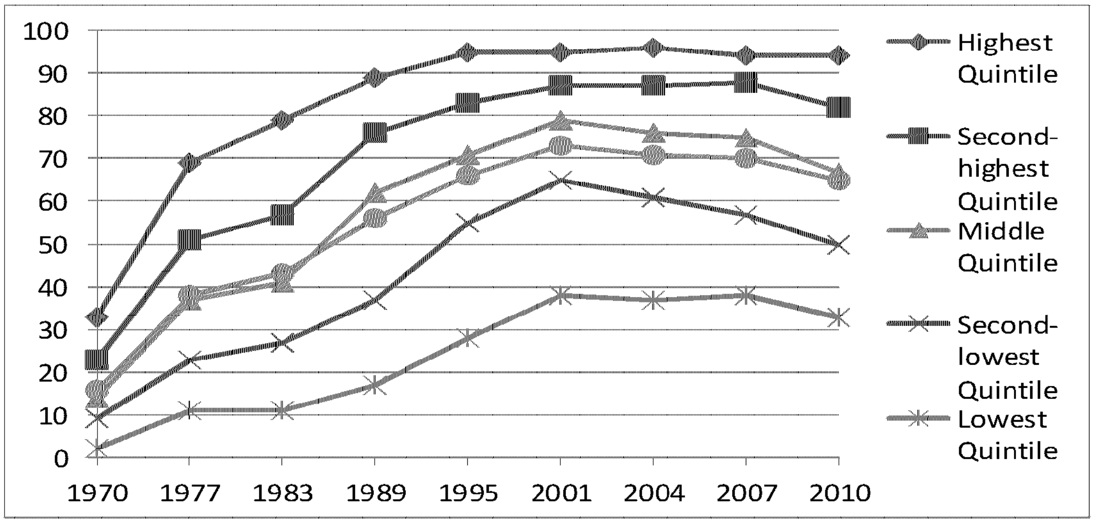
[103] *See* Christopher R. Knittel and Victor Stango, *Price Ceilings as Focal Points for Tacit Collusion: Evidence form Credit Cards*, 93 AM. ECON. REV. 1703 (2003).

[104] "Bank-type card" refers to a general purpose credit card that is generally accepted at most merchants, such as a card issued by a bank under the Visa or MasterCard logo, or a similar card issued by American Express or Discover, which also issue general purpose credit cards but do not partner with a bank to do so.

[105] For an extended discussion of the widening and deepening of credit card usage over time, *see* DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at Chapter 7, where data are compiled.

Figure 10-1: Prevalence of Bank type Credit Cards and Outstanding Balance Amounts, by Household Income Quintiles, Selected Years, 1970-2010, in Percent[106]





As discussed in Chapter 2 above, this dramatic growth in credit card holding has not resulted in any observable increase in household indebtedness over this period of

[106] Source: Surveys of Consumer Finances. In 1970, respondents were asked about *using* cards; in all other years, they were asked about *having* cards. Proportions that "have a card" are percentages of all households; proportions "carrying a balance" are percentages of holders of bank type cards with an outstanding balance after the most recent payment. Mean and median balances are for cardholders with outstanding balances after the most recent payment and are in 2004 dollars, adjusted using the Consumer Price Index for All Urban Consumers, all items. Shares may not sum to 100 percent because of rounding.

time; in fact, the household debt-service ratio today is lower than in 1980.[107] This surprising result—that the rapid spread of credit card access throughout the population has not increased overall household debt burdens—reflects how this growth in credit card usage has been a substitution from other traditional, less-preferred and more-expensive types of credit such as personal finance companies and retail store credit.[108] In comparison to those alternatives, bank-type credit cards were less expensive (especially after competitive pressures eliminated annual fees), more flexible in usage, offered more flexible repayment terms than traditional installment loans, and offered greater competition for the customer's patronage than products that were tied to one store or location.

As sophistication about risk underwriting grew, credit card issuers began competing more aggressively for consumers, especially more marginal consumers. During the years 1989 to 1995, credit card holding by households increased by 10 percentage points from 56 to 66 percent. New York Federal Reserve Bank economists Sandra E. Black and Donald P. Morgan found that cardholders in 1995 "were more apt to single, more likely to rent, and had les job security than cardholders in 1989."[109] There also was an increased share of younger households. The medial annual income of cardholders fell $4,700 between 1989 and 1995, and the share of cardholders that were middle or upper class (annual income over $25,000 in 1995 dollars) fell from 78 percent to 72 percent while the share of lower income cardholders rose from 22 percent to 28

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[107] *See* discussion in Chapter 2; *see also* DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**.
[108] *See* Zywicki, *Economics of Credit Cards*, *supra* note 27.
[109] Sandra E. Black and Donald P. Morgan, *Meet the New Borrowers*, 5(3) FEDERAL RESERVE BANK OF NEW YORK CURRENT ISSUES IN ECONOMICS AND FINANCE 1 (Feb. 1999).

percent.[110] As Black and Morgan concluded, "Credit cards are no longer a privilege of white-collar workers" but were increasingly accessible to lower-skilled blue-collar workers.[111]

Recent studies have confirmed the finding that increased competition in consumer finance markets increases financial inclusion. For example, deregulation of interstate bank branching in the United States led to a dramatic increase in access of low-income households to bank accounts, a significant reduction in the rate of unbanked households among low-income populations, an increase in wealth-building for low-income households, and an increase in the number of branches in lower-income areas.[112] The positive effect of increased financial access was largest for the lowest-income households below the poverty line and residents of rural areas.

C. Credit Reporting, Credit Scoring, and Financial Inclusion

Perhaps the most important contributing factor to greater financial inclusion in recent decades was the development of a comprehensive national credit reporting system and accompanying statistical credit scoring.[113] The creation and evolution of the comprehensive, largely-voluntary credit reporting system has blessed consumers with the "miracle of instant credit," in which an ordinary American literally could walk into a car dealership and drive home a brand new car just hours later.[114]

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[110] *Id.*
[111] *Id.* at 3.
[112] *See* Claire Celerier & Adrien Matray, *Bank Branch Supply and the Unbanked Phenomenon* (Oct. 17, 2016), *available in* https://www8.gsb.columbia.edu/faculty-research/sites/faculty-research/files/finance/Finance%20Seminar/Fall%202016/Unbanked_October2016.pdf.
[113] *See* DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at 216-229.
[114] *See* Timothy J. Muris, *Protecting Consumers' Privacy: Goals and Accomplishments* (June 22, 2002) (remarks provided at The Network Economy Summit, Reston, VA), *available in* https://www.ftc.gov/public-statements/2002/06/protecting-consumers-privacy-goals-and-accomplishments.

Until the development of statistical credit-scoring systems in the mid-1960s, consumer lending decisions were made individually by thousands of loan officers who exercised their individual judgment on each application. Their assessment generally relied on a combination of subjective and objective measures of risk. Creditors referred to the "five Cs of lending: character, capacity, capital, collateral, and conditions."[115] Each financial institution developed its own policies to guide these day-to-day lending decisions. But as lending volume increased in the post-War era it became increasingly difficult for banks, finance companies, and retailers to maintain consistent application of those policies among a growing number of lending officers. As credit operations of department stores and lending companies increasingly became regional and national in scope, one operator might have thousands of loan officers spread across hundreds of stores in dozens of states.[116] This highly individualized and somewhat subjective system of making credit assessments also raised concerns that discretion could be exercised in a discriminatory fashion against members of some demographic groups.

The growth in lending scale produced a growing need by lenders for a less-expensive and more-consistent process for making credit determinations. In time, lenders started to rely on statistical evaluation of creditworthiness based upon this approach. Important developments included founding of a new company in 1956 by engineer William Fair and mathematician Earl Isaac to implement and sell the Fair Isaac credit scoring system.[117] As early as the 1960s, studies of the effectiveness of even early statistical credit scoring models showed they could make more accurate decisions at

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[115] *See* DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at 216-229.
[116] *Id.* at 217.
[117] *Id.* at 220.

lower cost than traditional judgment-based models. This could allow lenders to expand their operations to a growing number of consumers at lower cost while suffering minimal increased losses. Over time, individual lenders developed their own proprietary scoring models, followed by generic, standardized credit scoring models using data from credit reporting agencies (CRAs, popularly known as credit bureaus). Reliance on scoring models soon became widespread in credit-granting decisions.

The growing use and sophistication of credit scoring enabled the explosion of credit card access after the Supreme Court's *Marquette* decision. Over time, the growing sophistication and use of credit scoring models enabled the birth and growth of risk-based pricing models for lending decisions, allowing greater tailoring of product terms to a consumer's predicted level of risk. The evolution of risk-based pricing, in turn, led to an expansion of credit to higher-risk borrowers and lower prices for lower-risk borrowers, without increasing loss rates.[118] As discussed in chapter 9 as well as below, creditors and credit reporting agencies have continued to innovate in their credit scoring models to make increased use of new and valuable alternative data that traditionally have not been included in credit scores, such as payments on recurring financial obligations such as utilities and rent as well cash-flow data.

Credit reporting and credit scoring models also facilitated market entry and competition.[119] A consumer's current financial provider possesses a large amount of private information based on its experience with that consumer, which provides it with an

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[118] *Id.* at 227; *see also See* BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, REPORT TO CONGRESS ON CREDIT SCORING AND ITS EFFECTS ON THE AVAILABILITY AND AFFORDABILITY OF CREDIT (Aug. 2007); Wendy Edelberg, *Risk-Based Pricing of Interest Rates for Consumer Loans*, 53 J. OF MONETARY ECON. 2283 (2006).
[119] DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at 268-69.

information advantage over potential competitors. This information advantage also creates an adverse selection problem for other potential providers because it implies those consumers who are seeking credit are have already been rejected for credit by the potential provider with the greatest knowledge of their circumstances. Credit reporting and credit scoring systems reduce the information asymmetry between lenders and borrowers (as described in chapter 11) but also between an individual's current provider and potential alternative suppliers. The rapid entry of new firms into the credit card market following the Supreme Court's decision in the *Marquette* case illustrates the value of credit scoring systems in promoting competition.

Statistical credit scoring systems have also been particularly important in reducing concerns about discrimination in lending. By substituting statistical underwriting models for the individualized assessments of thousands of loan officers, credit scoring systems made credit granting processes more transparent and consistent than previously, thereby reducing concerns about racial discrimination in credit-granting decisions. Research by the Federal Reserve Board has determined that credit scoring models are generally accurate across different demographic groups.[120]

IV. Consumer Demand For Financial Inclusion: Profile of Excluded Consumers

A. Who are the Unbanked and Why are they Unbanked?

[120] *See* FEDERAL RESERVE BOARD, REPORT TO CONGRESS, *supra* note 118; Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *Does Credit Scoring Produce a Disparate Impact?*, 40 REAL ESTATE ECON. 965 (2012) (finding no disparate impact from use of credit scores on mortgage credit underwriting or pricing for race or gender but finding evidence of some disparate impact by age that lowers the credit score of older individuals relative to younger).

According to the Federal Deposit Insurance Corporation (FDIC), in 2019 an estimated 5.4 percent of U.S. Households were classified as "unbanked" meaning that no one in the household had a checking or savings account at a bank or credit union.[121] This represents about 7.1 million U.S. Households. The Federal Reserve estimates that about six percent of American adults did not have a checking, savings, or money market account in 2019.[122] In addition, 16 percent of adults were considered "unbanked," meaning they had a bank account but also used an alternative financial service product such as a money order, check cashing service, or similar product. Half of unbanked adults used some form of alternative financial service.[123] Unbanked rates are higher than average for lower-income and less-educated households, minority households (Black, Hispanic, and American Indian), working-age disabled households, and households with more volatile income.[124]

A central element of the FDIC survey is to ask unbanked consumers why they do not have a bank account.[125] Over the last several FDIC surveys, the primary reason offered by unbanked households for not having a bank account is some variation on the response that they "Don't Have Enough Money to Meet Minimum Balance

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121 FEDERAL DEPOSIT INSURANCE CORPORATION, HOW AMERICA BANKS: HOUSEHOLD USE OF BANKING AND FINANCIAL SERVICES, 2019 FDIC SURVEY 1 (2020) (hereinafter 2019 FDIC SURVEY). This is a decline of 1.1 percentage points over 2017. About half of the decline in the unbanked rate was the result of improvements in socioeconomic circumstances of U.S. households over that period.

122 BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, REPORT ON THE ECONOMIC WELL-BEING OF U.S. HOUSEHOLDS IN 2019, FEATURING SUPPLEMENTAL DATA FROM APRIL 2020, at p. 27 (May 2020).

123 *Id.*

124 2019 FDIC SURVEY, *supra* note 120, at 1.

125 We leave aside discussion of those consumers who choose not to use mainstream financial products for non-benign purposes such as tax evasion, avoidance of legal judgments and garnishments, or to facilitate criminal activities. In the biannual FDIC surveys of unbanked and underbanked households, one of the top-five answers has typically been some variation of "avoiding a bank gives more privacy," which might be an indirect (and imperfect) measure of a desire to avoid scrutiny of one's financial activities. For example, in the 2019 version of the survey, that answer was the third-most common answer, with 36 percent of respondents identifying it as one reason for not having a bank account and 7 percent identifying it as the "main" reason. 2019 FDIC SURVEY, *supra* note 121, at 17, Fig. 3.5 (2020)

Requirements" or they "Do not have enough money to keep in account." In 2019, 48.9 percent stated the inability to meet the minimum balance requirement as a reason for not having a bank account and 29 percent cited it as the "main" reason for not having an account, almost double the that of the second most common reason. The related answer, "Bank Account Fees Are Too High" was cited by 34.2 percent of unbanked consumers as a reason for not having a bank account with 7.3 percent citing that as the "main" reason.[126]

In 2017, 52.7% of unbanked consumers cited not having enough money to maintain a bank account as a reason for not having an account and 34% cited it as the "main" reason.[127] Another 8.6% of respondents in 2017 said they did not have bank accounts because "Account fees [were] too high."[128]

Although the pattern of these answers has been generally consistent over the last several surveys, they differ from the earlier patterns of answers. The 2011 and 2009 surveys asked different questions and unbanked consumers answered them in different ways, so they are difficult to compare to the more recent surveys.[129] Nevertheless, what is

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[126] 2019 FDIC SURVEY, *supra* note 121.

[127] FEDERAL DEPOSIT INSURANCE CORPORATION, 2017 FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS 4, Fig. ES.4 (Oct. 2018).

[128] This ordered ranking of the "Main" reason for not having a bank account has been consistent for several years. In the 2015 Survey, for example, 37.8% cited "Do not have enough money to keep in account," 10.9% said "Don't trust banks," and nearly as many (9.4%) said "Account fees too high" and another 1.9% said "Account fees unpredictable." In that survey, 5.3% cited "Inconvenient locations" and "Inconvenient hours" combined as the main reason for not having a bank account. FEDERAL DEPOSIT INSURANCE CORPORATION, 2015 FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS 3, Fig. ES.2 (Oct. 20, 2016). The 2013 survey again found similar figures. Notably, after "Do not have enough money" (which 35.6% cited as the main reason), 14.9% said "Don't like dealing with or don't trust banks," and 13.4% listed as the main reason "Account fees are too high or unpredictable." FEDERAL DEPOSIT INSURANCE CORPORATION, 2013 FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS 7, Fig. ES.3 (Oct. 2014).

[129] *See* FEDERAL DEPOSIT INSURANCE CORPORATION, 2011 FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS 27, Fig. 5.9 (Sept. 2012); FEDERAL DEPOSIT INSURANCE CORPORATION, 2009 FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS 25, Fig. 4.12 (Dec. 2009).

revealing is that in the 2011 survey, only 4.0% of never-banked households reported that they reason they did not have a bank account was because "Bank account fees or minimum balance requirements are too high," a figured that had more than tripled by 2013 to 13.4% in answers to an analogous question. This figure has remained about 10% in every survey since that time. Similarly, in 2009 only 6.3% of unbanked consumers said that "Service charges are too high" was the reason why they did not have a bank account compared to 34 percent in the most recent survey. The cost of maintaining a bank account has emerged as a primary obstacle to more widespread access to bank accounts in recent years.

Beyond the high cost of a bank account, the second reason why many consumers choose not to have a bank account is because they do not trust banks. In the 2019 Survey, "Don't Trust Banks" was cited by 36 percent of unbanked consumers as a reason and 16 percent as the main reason.[130] It is not clear what exactly unbanked consumers mean when they provide this answer as it covers a broad swath of possible responses. Comparison of recent surveys to earlier editions of the FDIC survey suggests that this relatively generic answer captures a constellation of factors beyond a literal distrust of banks. For example, the first FDIC survey conducted in 2009 provided a larger number of prompted possible responses at a more disaggregated level than the recent versions of the survey. They included possible answers like "Banks do not feel comfortable or welcoming" (offered by 9.1 percent of respondents) and "There are language barriers at banks" (offered by 6.9 percent) in addition to the response "Do not trust banks" (6.3

[130] In the 2017 Survey "Don't Trust Banks" was also the second most common response as both a cited reason (30.2%) and main reason (12.6%) for not having an account.

percent).[131] Given the lack of any clear comparable options in more recent editions of the FDIC surveys, it seems plausible that these expressed concerns about "feeling welcome," facing language barriers, and other comparable obstacles are being included in recent surveys in the respondents' selection of "Don't Trust Banks" as a response in light of the small number of respondents who selected that option when other seemingly related options were offered in the past. Leaving aside cost and other considerations, this answer suggests that many consumers would be willing to open a bank account if this "trust" hurdle could be overcome.[132]

Unbanked consumers might also distrust banks because they feel like banks present many traps for the unwary—bank accounts are complicated and can be difficult to manage, especially by those with limited funds and financial sophistication. Alternative financial providers, by contrast, generally offer very simple and transparent terms with few surprises and "hidden" fees.[133] Even if fees for these products are higher (and in many instances they are not), consumers may feel like those fees are at least comprehensible, transparent, and predictable.

With respect to use of certain specific alternative financial services such as check cashing and money orders, a large driver of usage is not actually lack of access to a bank account but a need for convenience and speed in gaining access to their funds. The FDIC's 2019 Survey, for example, found that 17 percent of households that have a bank account have also used some form of money transaction service such as a money order,

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[131] *See* 2009 FDIC SURVEY, *supra* note 129, at 25, Fig. 4.12.
[132] This feeling of trust, feeling welcome, or feeling valued as a customer is a common explanation given by many consumers for why they use alternative financial providers such as payday loans instead of mainstream providers. *See* LISA SERVON, THE UNBANKING OF AMERICA: HOW THE NEW MIDDLE CLASS SURVIVES (2018).
[133] *Id.*

check casher, or bill payment service, almost always to pay a bill.[134] Prior versions of the survey indicate that a primary reason why households with a bank account still use these alternative transaction services is because of their speed and convenience to get access to their money so that they can pay bills on time. .[135] Banks inexplicably can still take three days or longer to grant customers access to their deposits.[136] Fedwire and the National Settlement Service, two wholesale payment services used to settle payments flows electronically, are closed on weekends, thus consumers who need access to their money over the weekend can face particularly long delays.[137] Dealing with these delays in payment processing can be especially difficult for low-income consumers who live paycheck-to-aycheck and are unable to maintain substantial buffers in their bank accounts to cover flows of funds in and out of the account.[138] The Taskforce has located no sound evidence as to how much usage of expensive alternative financial services could be reduced by a faster payments system..[139] Further research on this point is warranted.

Another general category of reasons why consumers say they are unbanked cover the general category of "Personal, Identification, Credit or Former Bank Account Problems." Although this problem is not widespread, it is an overwhelming obstacle for

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[134] *See* 2019 FDIC SURVEY, *supra* note 121, at 35.
[135] *See* 2011 FDIC SURVEY, *supra* note 129, at 37. Many respondents also said that banks charged more to acquire these services than non-bank alternative financial providers.
[136] *See* George Selgin and Aaron Klein, *We Shouldn't Have to Wait for FedNow to Have Faster Payments*, AM. BANKER (Feb. 28, 2020).
[137] *Id.*
[138] *See* Federal Reserve Board Governor Lael Brainard, *Delivering Faster Payments for All* (Aug. 5, 2019), *available in* https://www.federalreserve.gov/newsevents/speech/brainard20190805a.htm.
[139] *See* Aaron Klein, *The Fastest Way to Address Income Inequality? Implement a Real time Payment System*, WWW.BROOKINGS.EDU (Jan. 2, 2019), *available in* https://www.brookings.edu/research/the-fastest-way-to-address-income-inequality-implement-a-real-time-payment-system/; Aaron Klein, *Real-Time Payments Can Help Combat Inequality*, WWW.BROOKINGS.EDU (Mar. 6, 2019), *available in* https://www.brookings.edu/opinions/real-time-payments-can-help-combat-inequality/.

those impacted by it. For example, in the 2019 FDIC survey of unbanked consumers, answers to this effect ranked only sixth of ten prompted answers as being a reason for not having a bank account, but it ranked *third* as the "main" reason for not having an account. As suggested by the category, in some instances this obstacle arises from problems with managing a bank account earlier in life that resulted in having one's bank account involuntarily closed.

But many respondents also report that issues with "personal identification" are also an obstacle. In some instances this lack of personal identification can arise from one's status as an undocumented immigrant.[140] Some of those who lack sufficient identification or credit history may also be ex-convicts who after serving lengthy prison sentences might lack a recent credit history or were victims of identity theft while in prison.[141] Ex-convicts are much more likely to use alternative financial products than the general population, with the largest disparities in product use exhibited with products that are most heavily used by unbanked populations, such as check cashers and pawn shops.[142] Because of demographic differences in incarceration rates among races, difficulty of ex-convicts in accessing the banking system upon release also reinforces

[140] 16.2 percent of foreign-born non-citizen households lack a bank account, compared with 5.9 percent of U.S.-born and 4.8 percent of foreign-born citizen households. *See* FEDERAL DEPOSIT INSURANCE CORPORATION, 2017 FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS: APPENDIX TABLES, *supra* note, at 6, Table A.3 *See also* Diego Zuluaga, *Going Postal? Proposals for Post-Office Banking in 2020*, WWW.ALT-M.ORG (Oct. 16, 2020), *available in* https://www.alt-m.org/2020/10/16/going-postal-proposals-for-post-office-banking-in-2020/. Although legal immigrants do not necessarily have identification or documentation issues they do face challenges because of a lack of reportable credit and financial history.

[141] *See* David Benoit, *Ex-Inmates Struggle in Banking System*, WALL ST. J. at p. B9 (Nov. 2, 2020).

[142] *See* Marc D. Glidden and Timothy C. Brown, *Separated by Bars or Dollar Signs? A Comparative Examination of the Financial Literacy of Those Incarcerated and the General Population*, 42 AM. J. CRIM. JUSTICE 533 (2017); *see also* Marc D. Glidden, Timothy C. Brown, Molly Smith, and Mary H. Hughes, *Prisoners with Purses: The Financial Literacy and Habits of Incarcerated Women*, 5 CORRECTIONS: POLICY, PRACTICE, AND RESEARCH 377 (2018).

racial disparities in access to financial products.[143] The Taskforce urges the CFPB, HUD, and other relevant bodies to examine the difficulties confronted by ex-convicts in establishing access to financial products upon release and to consider efforts to alleviate barriers where possible.

This lack of personal identification and similar paperwork barriers might also be a by-product of the application of anti-money laundering and bank secrecy act laws that raise the economic costs and regulatory and identification barriers to banks of providing financial services to non-traditional customers.[144] Anti-money laundering laws have also been identified as a potential barrier to fintech development,[145] despite how greater use of fintech to facilitate cross-border transactions could simultaneously increase both financial inclusion and anti-money laundering compliance[146]. As part of its research outreach and dialogue with governmental and non-governmental stakeholders, the Taskforce has tried to determine the extent to which compliance with anti-money laundering laws and risk-management imposes an undue burden on financial inclusion but has not been able to make that determination. The Taskforce recognizes, of course, that these laws play a legitimate and important purpose in preventing terrorism and the facilitation of criminal activity. But the Taskforce also notes the concern that many have expressed for ensuring that the application of these laws does not unduly interfere with the goal of financial inclusion. As observed by a World Bank study several years ago, "[T]he Financial Action

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[143] *See* Benoit, *supra* note 141.

[144] *See* Daniel J. Mitchell, *Money Laundering Laws: Ineffective and Expensive*, CATO AT LIBERTY (Oct. 22, 2016), *available in* https://www.cato.org/blog/money-laundering-laws-ineffective-expensive; Daniel J. Mitchell, *World Bank: Anti-Money Laundering Rules Hurt the Poor*, CATO AT LIBERTY (Apr. 20, 2012), *available in* https://www.cato.org/blog/world-bank-anti-money-laundering-rules-hurt-poor.

[145] *See* David R. Burton and Norbert J. Michel, *Financial Privacy in a Free Society*, HERITAGE FOUNDATION BACKGROUNDER 14-15 (Sept. 23, 2016).

[146] *See* MICHAEL BARR, KAREN GIFFORD, AND AARON KLEIN, ENHANCING ANTI-MONEY LAUNDERING AND FINANCIAL ACCESS: CAN NEW TECHNOLOGY ACHIEVE BOTH?, The Brookings Institution (Apr. 2018).

Task Force, recognizing that overly cautious Anti-Money Laundering and Terrorist Financing (AML/CFT) safeguards can have the unintended consequence of excluding legitimate businesses and consumers from the financial system, has emphasized the need to ensure that such safeguards also support financial inclusion."[147] The view of the Taskforce is that this issue warrants more focus and research across the government to ensure that anti-money laundering and terrorist financing laws are well-tailored to the accomplishment of their goals with minimal adverse impact on innocent consumers.

B. "Credit Invisibles"

As discussed above, the development of the comprehensive national credit reporting system has been one of the major catalysts for growing financial inclusion in the American consumer financial sector. Yet many Americans remain outside the traditional credit reporting system and as a result are unable to gain access to many mainstream financial products on beneficial terms."[148]

There are two groups of consumers with limited credit histories.[149] The first are those who lack credit records with the three nationwide credit reporting agencies, which the CFPB refers to as "credit invisibles." The second category the CFPB refers to as "unscorable," meaning "they contain insufficient credit histories to generate a credit score.[150]

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[147] ASLI DEMIRGUE-KUNT AND LEORA KLAPPER, MEASURING FINANCIAL INCLUSION: THE GLOBAL FINDEX DATABASE 20, World Bank Policy Research Working Paper 6025 (Apr. 2012).
[148] *See* CONSUMER FINANCIAL PROTECTION BUREAU, DATA POINT: CREDIT INVISIBLES (May 2015).
[149] *Id.* at 4.
[150] The CFPB identifies two basic reasons why a credit record might be considered unscorable, either because it contains "insufficient information to generate a score" (such as too few accounts or those accounts are too new) or because the account has become "stale" because "it contains no recently reported activity." *Id.* at 4.

Examining data collected in 2010, the CFPB estimated that 26 million consumers were credit invisible, representing approximately 11 percent of the adult population, and an additional 19 million consumers, or 8.3 percent of the adult population were considered unscorable.[151] Residents of low-income neighborhoods, Blacks, and Hispanics, were all more likely to be credit invisible or unscorable than residents of high-income neighborhoods, Whites, or Asians. Age, however, was also a significant predictor of the likelihood of being credit invisible or unscorable, which suggested "that those differences materialize early in the adult lives of those consumers and persist after."[152] This further suggests that interventions designed to increase the likelihood of having a scored credit record would be most effective early in adulthood.

V. Fair Lending and Discrimination

In addition to facially-neutral laws and regulations such as usury ceilings that have impacted financial access for all, some Americans have also faced direct or indirect discriminatory barriers based on their race, sex, immigrant status, or other personal demographic characteristics. American history provides ample examples of mistreatment by banks, retailers, and others based on animus and crude and unjustified stereotypes about groups of people. Perceived persistence of these discriminatory practices in financial services provision animated the landmark Equal Credit Opportunity legislation of the 1970s that prohibited discrimination in the provision of financial services on the basis of the enumerated characteristics.

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[151] *Id.* at 6; *see also* Alyssa Stewart Lee, Ann Schanave, Michael A. Turner, Patrick D. Walker, and Robin Varghese, *Give Credit Where Credit is Due: Increasing Access to Affordable Mainstream Credit Using Alternative Data* (Brookings Institution, 2006) (estimating 35 million to 54 million consumers in 2006 with limited or no credit files).
[152] CREDIT INVISIBLES, *supra* note 148, at 6.

In some instances, this discrimination might have been intended by banks or department stores to deter patronage by certain categories of consumers. In other instances, discrimination might have arisen from the discretion afforded to loan officers and other bank employees through the decentralized and judgmental system of lending that prevailed prior to the widespread adoption of credit scoring systems. By protecting banks and finance companies from competition, regulatory barriers to market entry created conditions where discriminatory practices could persist. This section reviews the history of lending practices in the United States that culminated in the enactment of ECOA. It then turns to a review of legal and other regulatory barriers that presented barriers to financial inclusion of minority groups, including usury ceilings and expressly discriminatory laws that facilitated discrimination in housing markets.

A. Historical Context of Unequal Treatment in Provision of Financial Services

Two groups of Americans faced notable challenges to full inclusion in the post-War consumer finance revolution: poor urban minorities (mainly Black) and women, especially the rising class of educated, affluent, professional women.[153] As economic historian Louis Hyman has noted, "Even as the credit problems of affluent, white women and poor, black Americans emerged for different reasons and with different consequences, credit reformers lumped both as discrimination."[154] Even though they were "lumped together" under the general heading of "discrimination," the historical and

[153] The challenges facing poor rural populations at the time were largely ignored by scholars, reformers, and policymakers at the time and remain little-analyzed today. The distinct issues confronting rural populations in the provision of financial services would be a useful topic of additional research, especially in light of regulatory developments that have disproportionately impacted the viability of rural and small-town financial providers.

[154] LOUIS HYMAN, DEBTOR NATION: THE HISTORY OF AMERICA IN RED INK 173-74 (2011).

economic causes of their unequal treatment varied dramatically and potential remedies to address those inequalities varied dramatically as well. Concerns about unfair discrimination with respect to these groups, and eventually others as well, culminated in the passage of a series of laws in the late 1960s and early 1970s that intended to eliminate discrimination in the provision of credit.

1. Financial Inclusion and Black Consumers

The problem of unequal access and terms of credit by minorities arose from a complex and interlocking network of self-reinforcing conditions, largely rooted in "ghetto poverty" (to use the contemporary terms of the era), that made addressing those problems difficult to address and fraught with challenging tradeoffs and potential unintended consequences.

As discussed in Chapter 2, the rising prosperity and migration of middle-class White families to the suburbs in the post-War era brought with it an unprecedented demand for mortgages and consumer goods, especially durable goods such as automobiles and modern household appliances. As discussed above, this rapid increase in demand for consumer goods and accompanying demand for consumer credit overwhelmed the traditional labor-intensive, subjective judgment-based system of credit evaluation by lending officers. The growing size and interstate nature of department stores and finance companies also brought with a desire for greater efficiencies and consistency in credit-granting decisions. These market developments prompted the creation of prototype credit reporting and scoring models that enabled rapid and accurate assessments of a prospective customer's credit worthiness. In turn, the growing use of standardized credit scoring models prompted increased choice for consumers to shop for credit and increased competition and entry by new credit grantors. As noted above, because of the continued distorting effect of usury ceilings, much of the financing of the purchase of consumer durables was provided by retailers, thus for many middle-class consumers shopping for goods and credit were intertwined, thus pricing was not as transparent and competition was not as effective as it might otherwise be. Nevertheless, during the post-War era, middle-class consumers shopped in a robust market that provided high quality goods on competitive terms.

The experience of poor urban minorities, however, was far different. Black families continued to disproportionately live and work in large cities in older stock housing. The continued concentration of Blacks in urban areas was largely attributed to the negative feedback loop created by poverty and lack of economic development that made migration to the suburbs unaffordable as well as government-imposed segregation in residential mortgage markets (as discussed below).

The system of urban poverty created a self-reinforcing, closed system dynamic that created a separate and inferior system of consumer credit for the urban poor that centered on the retail sales industry in poor urban neighborhoods. Because of their tight budget constraints, poor families were much more reliant than prosperous middle-class families on access to credit for credit to make purchases of durable goods, and even many nondurable goods. Yet because they had lower incomes and fewer assets, they tended to promote a higher risk profile. Prevailing usury ceilings and entry barriers made it economically infeasible for banks, finance companies, or credit unions to compete in low-income neighborhoods with higher-risk borrowers.[155] Retailers, however, could circumvent usury ceilings by increasing the price of the goods they sold on credit to higher-risk borrowers. This meant that higher-risk consumers were almost completely dependent on retailer-provided credit for consumer purchases and there was virtually no competition from finance companies or other potential legal credit providers. As a result of this offsetting term repricing behavior by retailers, prices paid by poor consumers for products purchased on credit at neighborhood stores were substantially higher than for the same products purchased by middle-class consumers on credit elsewhere. A study commissioned by the NCCF by economists George Day and William Brandt found that while just over half of middle and upper income White families obtained their credit through retailers, the figure was 80 percent for minority consumers and about 70 percent for low income Whites.[156]

The quality of goods purchased at stores serving lower-income communities also was often inferior to that offered to middle-class consumers. Moreover, because almost all higher-risk consumers were effectively forced to make a joint purchase of goods and credit, it was difficult for them to discern the true cost of either element of the transaction and therefore difficult to engage in comparison shopping. This combination of elements led to the widespread perception that retailers in urban neighborhoods were guilty of "selling… shoddy merchandise at high prices on credit with usurious rates."[157]

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[155] For example, according to the NCCF at that time there were no small loan companies operating in Harlem or the District of Columbia at that time and credit unions had relatively few low income members. *See* NCCF Report, *supra* note 3, at 180.
[156] GEORGE S. DAY AND WILLIAM K. BRANDT, A STUDY OF CONSUMER CREDIT DECISIONS: IMPLICATIONS FOR PRESENT AND PROSPECTIVE LEGISLATION, NATIONAL COMMISSION ON CONSUMER FINANCE STUDIES Vol. 1 (1972); *see also* NCCF REPORT, *supra* note 3, at 180.
[157] HYMAN, *supra* note 154, at 175.

According to David Caplovitz in his famous book, *The Poor Pay More*, 75 to 90 percent of purchases of household goods by low-income households were made on credit.[158] Similarly, a 1968 Federal Trade Commission study found that 93 percent of household goods sales to low-income households were made on credit compared to 27 percent of purchase in "general" goods markets.[159] Moreover, although the stated average finance charge on credit provided by low-income and "general" market retailers was comparable, the mark-up price on their products was 2.55 times the wholesale price at low-income retailers versus only 0.59 times at general market retailers. The high demand for credit of lower-income and younger households, combined with the lack of competitive supply as a result of usury laws, effectively created market power for the providers of appliances and other household goods for low-income consumers, enabling them to extract even higher prices from those consumers.

Why did lower-income families not leave their neighborhoods to shop at less-expensive stores? Primarily because they would have been unable to obtain credit there. As Hyman notes, "Local neighborhood merchants offered them credit that many poorer consumers could not get at the lower-priced downtown or suburban stores."[160] Because they could buy on credit at local stores but not elsewhere, lower-income consumers were able to shop more effectively at local stores. But stores that specialized in serving lower-income neighborhoods stood apart from the mainstream system of consumer finance;

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[158] DAVID CAPLOVITZ, THE POOR PAY MORE 16-20 (1967). Caplovitz's study was originally published in 1963.
[159] *See* FEDERAL TRADE COMMISSION, ECONOMIC REPORT ON INSTALLMENT CREDIT AND RETAIL SALES PRACTICES OF DISTRICT OF COLUMBIA RETAILERS (1968); *see also* DURKIN, ET AL., *supra* note, at 514.
[160] HYMAN, *supra* note 154, at 176.

thus, shopping at those specialized stores meant that lower-income consumers remained largely invisible to the organized credit reporting system.

"Without credit references, much less credit ratings, downtown stores would not extend ghetto residents credit," which reinforced "ghetto" residents' dependence on local merchants.[161] Many "downtown" department stores also excluded Black patrons through formal or informal measures.[162] Boxed in on one side by the inability to obtain credit from lower-priced "downtown" department stores because they lacked credit references and on the other by usury ceilings and entry barriers that foreclosed competition from finance companies and other cash credit providers, lower-income consumers were locked in a self-perpetuating cycle of growing dependence on local stores that provided credit on anticompetitive terms. As Hyman observes, "The necessity of consumer credit to buy modern merchandise on a limited income bound poorer consumers to local merchants, who charged higher prices and higher interest rates than the merchants in more affluent areas. Ghetto consumers comparison-shopped less than their middle-class analogues and did not search out the lowest possible prices, opting instead to shop locally."[163]

Thus, what was often characterized as a lack of diligence or understanding by lower-income consumers in engaging in comparison shopping may have reflected a lack

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[161] HYMAN, *supra* note 154, at 176 ("Credit tied lower-income consumers to neighborhood merchants, who enabled them to buy more, but at higher prices.").

[162] *See* TRACI PARKER, DEPARTMENT STORES AND THE BLACK FREEDOM MOVEMENT: WORKERS, CONSUMERS, AND CIVIL RIGHTS FROM THE 1930S TO THE 1980S at p. 15-25 (2019).

[163] HYMAN, *supra* note 154, at 176; *see also* discussion at *supra* notes 46-**Error! Bookmark not defined.** and accompanying text (noting reduced competition on APR in states with lower usury rate ceilings). In a similar vein, although the lack of awareness of prevailing interest rates on various types of consumer financial products is often attributed to a lack of education, it more plausibly reflects the reality that many of those products are not viable options for low-income consumers thus they do not pay attention to the prices and instead focus on terms that are more relevant to their decision. *See* NCCF REPORT, *supra* note, at 179-180 (attributing lack of awareness by lower-income households of rates on credit union loans to the fact that credit unions had very few low-income members).

of incentives to shop as a result of the limited benefit that would be obtained from doing so in light of their restricted choices. Instead of competing on price, as middle-class retailers did, lower-income merchants competed mostly on ease of credit terms.[164] Research sponsored by the NCCF found that lower-income and higher-risk consumers showed much less awareness of APRs than higher-income, more highly-educated, and lower-risk consumers.[165] But this finding might have reflected the lack of competition for higher-risk borrowers with respect to APR that was a byproduct of binding usury ceilings which reduced the incentive and ability of higher-risk consumers to shop for credit terms.[166] Thus, the same research found that almost all buyers knew the maturity, amount finance, and monthly payment associated with their credit.[167]

Despite charging high prices, "ghetto merchants" actually earned lower profits than mainstream competitors.[168] Costs of operation and default losses were high. One reason for high defaults was the feeling by some borrowers that they had been given a raw deal—the shoddy goods they received did not justify the high prices and finance charges they paid. As a result, they simply stopped paying. To contain high losses in the face of high default rates, lower-income merchants insisted on providing credit on an installment basis with the goods serving as collateral that lenders could repossess upon

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[164] This feature of competing on ease of access instead of price is not unique to lower-income markets, but is prominent in any market where supply is restricted by usury ceilings or other regulations.
[165] GEORGE S. DAY AND WILLIAM K. BRANDT, A STUDY OF CONSUMER CREDIT DECISIONS: IMPLICATIONS FOR PRESENT AND PROSPECTIVE LEGISLATION, NATIONAL COMMISSION ON CONSUMER FINANCE STUDIES Vol. 1 (1972).
[166] *See* NCCF REPORT, *supra* note 3, at 182 ("Nor does this represent "irrational" behavior on the part of consumers. The dominance of the cash price In the total time price, the scarcity of legal cash credit, and the ability of retailers serving low income consumers to blur the level of the finance charge by stretching maturities or raising cash prices, causes these consumers to place little reliance on the disclosed APR in their shopping.").
[167] *Id.*
[168] *See* NCCF REPORT, *supra* note 3, at 181 (citing FEDERAL TRADE COMMISSION, *supra* note 159).

default.[169] Low-income merchants also aggressively pursued legal remedies for unpaid balances. These practices differed dramatically from those of mainstream department stores, which by this time had largely adopted unsecured revolving charge accounts and rarely sued for unpaid balances.[170] These troubles associated with default, repossession, and subsequent lawsuits fed back into the troubles of lower-income consumers, further undermining their ability to shop and obtain credit from stores outside the "ghetto."

Addressing the financial issues of the urban poor focused on breaking this cycle of lack of consumer choice and institutional competition that made them dependent on these providers. Remedies to increase choice and competition focused on two basic approaches: to either bring greater competition *into* the "ghetto" by increasing the quality and quantity of competitors in the neighborhood or to help "ghetto" consumers *outside* of the neighborhood by enabling them to shop at the same stores as middle-class consumers by improving their credit options.

Bringing competition to the "ghetto" involved eliminating existing barriers to competition and supporting potential new entrants. The most obvious target was the elimination of usury ceilings and barriers to entry (such as "convenience and advantage" requirements for opening a new small-loan company) that made it economically infeasible for banks and finance companies to operate profitably. Because of these limits on pricing and entry, only those companies that successfully circumvent usury ceilings by raising prices could survive in urban areas. But, as noted, this created market power in the

[169] *See* HYMAN, *supra* note 154, at 178; *see also* Martha L. Olney, *When Your Word is Not Enough: Race, Collateral, and Household Credit*, 58 J. ECON. HIST. 408 (1998) (finding that during the 1920s Black families were about twice as likely to use installment credit as White families even though overall amounts of credit were comparable between the two groups).
[170] *See* HYMAN, *supra* note 154, at 178.

hands of local retailers and made pricing less transparent by tying together credit transactions and purchases of goods. Opening the local market to greater competition, including from banks, finance companies, and mainstream department stores would drive out of business exploitative retailers and replace them with lower-priced and higher-quality providers.[171]

Restrictions on branch banking in many states also prevented entry by successful banks.[172] Even where branching was permitted by law, other social and economic factors raised novel challenges. Because of the higher loss rate of loans to inner-city borrowers, banks would be required to charge higher interest rates than charged to lower-risk populations in the suburbs or elsewhere in the city. This gave rise to a fear of a public relations controversy from charging a higher interest in minority neighborhoods than elsewhere, even if risk-justified.[173] And even if a low-risk minority borrower came to the main office, banks feared the potentially bad publicity that would occur from "pulling the strings" on a minority borrower in the event of default. Ironically, the fear of being criticized for making loans on discriminatory terms and conditions led many banks to simply avoid opening branches in minority neighborhoods or lending to minority borrowers. Moreover, the low rate of investment return for incumbent stores operating in inner cities was not encouraging to stores considering entering the market.

A related, but inconsistent strategy, involved building up new locally-owned retailers and banks into viable competitors to the exploitative retailers. Usually this meant

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[171] Ironically, Senator William Proxmire, who was an advocate for this strategy also penned a dissenting opinion from the NCCF Report where he criticized the Commission's proposal to raise prevailing usury rate ceilings. *See Separate Statement of Senator William Proxmire*, NCCF REPORT, *supra* note, at 220.
[172] HYMAN, *supra* note 154, at 185.
[173] HYMAN, *supra* note 154, at 185.

primarily directing credit to promote small-business lending that would encourage local economic development, with direct provision of consumer finance a secondary consideration. This strategy of building up local competitors was in inherent conflict with the strategy of encouraging entry by firms from outside the neighborhood, as encouraging outside competitors to enter and supplant incumbent providers would dramatically increase access to credit but shift economic control outside the neighborhood while building up local institutions would have the opposite effect.

Efforts to promote Black-owned banks and retail businesses date back to the 19th century.[174] During much of the 19th century, Blacks in America relied on a variety of primarily informal financial relationships to meet their credit and banking needs as well as loans from churches, schools, and fraternal orders and secret societies.[175] Although the idea of a Black-owned bank was first discussed prior to the Civil War,[176] the first bank was not established until 1888, through the direct and indirect funding of mutual aid societies that evolved during Reconstruction.[177] The mission of these banks was to provide capital and credit to new businesses (especially service-oriented businesses in the Black community), to finance special projects sponsored by fraternal and mutual aid societies, and "to provide general banking services to the African American community, which had been ignored by most non-minority-owned banks."[178] From 1888 to 1928, these banks "served as the major outlet for African Americans to gain access to loans and

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[174] *See* Erik Johnson, *The Black Department Store on King Drive*, CHICAGO CRUSADER (Feb. 232, 2018), *available in* https://chicagocrusader.com/the-black-department-store-on-king-drive/.
[175] *See* TIM TODD, LET US PUT OUR MONEY TOGETHER: THE FOUNDING OF AMERICA'S FIRST BLACK BANKS (2019)
[176] *Id.*
[177] *See* Lila Ammons, *The Evolution of Black-Owned Banks in the United States Between the 1880s and 1990s*, 26 J. OF BLACK STUDIES 467 (1996); *see also* Amber Burton, Justin Scheck, and John West, *The Battle to Keep Black Banks Alive*, WALL ST. J. at p. B1 (Nov. 7-8, 2020).
[178] Ammons, *supra* note 177, at 471.

other banking services. This was particularly important because the majority of the non-minority-owned banks in existence during this era were unwilling to provide basic financial services to the African American community."[179]

During the turbulent era of the Great Depression, World War II, and the post-War era, however, Black-owned banks faced many challenges with an unstable banking system, a loan portfolio with a higher percentage of bad loans, inexperienced management, and a customer base with limited assets and collateral. More fundamental, Black-controlled banks typically had higher costs and lower returns than mainstream, White banks because of the small average size of their depositors' account balances and personal loans as well as the absence of large commercial checking accounts.[180] Moreover, opportunities for profitable reinvestment in the local community were scarce, leading many minority-owned banks to seek investment opportunities elsewhere. As a result, the prospect for Black-owned banks to become substantial viable rivals to established institutions was improbable.[181] Although the number of smaller banks has declined nationwide since the enactment of Dodd-Frank, the impact of increased regulatory costs has been especially severe for minority-owned banks.[182]

The alternative approach involved taking lower-income consumers out of the local neighborhood to bank and shop where middle-class people shopped and banked. This approach focused on developing the credit visibility of lower-income consumers and to help them establish credit records. Washington Urban League executive director John Jacob proposed the creation of a "credit card for urban residents" that would enable poor

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[179] *Id.*

[180] Hyman, *supra* note 154, at 184-85; *see also* Ammons, *supra* note **Error! Bookmark not defined.**177.

[181] Ammons, *supra* note **Error! Bookmark not defined.**, at 474-75.

[182] *See* Burton, Scheck, and West, *supra* note **Error! Bookmark not defined.**.

families to shop at any store they wanted, including in White areas.[183] Jacob adopt their payment schedules to their high level of income volatility. According to Jacob, revolving credit cards also would meet the needs of low-income urban consumers better than traditional installment loans because they provided flexible payment terms that were suitable to the high income volatility of the urban poor. "The unyielding fixed repayment plans of installment credit frustrated ghetto consumers, whose paydays could be as irregular as the debt due dates were regular."[184] Interest rates on credit cards, unlike department store installment credit, also could vary according to the borrower's degree of risk. According to Hyman, Jacob believed "most ghetto residents cared more about their own access to flexible credit than whether the lender was black or white."[185] Jacob also believed that encouraging existing institutions such as American Express to serve "ghetto" neighborhoods would lead banks to rethink their negative stereotypes of Black consumers and would help urban residents to overcome their traditional distrust of traditional banks.[186]

Consistent with this history and the prevailing understanding of the time, the view of the NCCF was that the financial problems of urban minority communities was primarily a problem of poverty and inadequate competition. In Chapter 8 of its report, entitled "Special Problems of Unavailability," the NCCF analyzed the question of discrimination in credit granting in non-mortgage consumer lending, with a special focus on questions of discrimination against women and racial minorities.

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[183] HYMAN, *supra* note 154, at 188.
[184] HYMAN, *supra* note 154, at 189
[185] *Id.*
[186] *Id.* at 190. Even today, as mentioned above a major reason why many people say they are unbanked is because they "don't trust banks."

With respect to the question of racial discrimination, the NCCF drew heavily on a study by Frederick D. Sturdivant and Walter T. Wilhelm entitled "Poverty, Minorities and Consumer Exploitation."[187] Sturdivant and Wilhelm sent three couples—one Black, one Hispanic, and one White—to shop for television sets at several retail stores in Los Angeles and compared the cash and credit prices offered to each. For purposes of the survey the credit profiles of three couples were claimed to be "similar" in terms of "family status, age of head of household, employment, income, savings, assets, and indebtedness." Examining the quoted prices to the various couples, Sturdivant and Wilhelm found minimal price dispersion in the cash prices that were quoted to the couples but substantial dispersion in the credit prices. However, they did *not* find evidence of racial discrimination—indeed, in 3 of the 8 sampled stores the White couple was offered the highest price and in only 2 stores was the White couple charged the lowest price. The fundamental problem, the authors concluded, was one of poverty and limited choice and the opportunities that provided for retailers to exploit a market power position through the credit terms charged to consumers.

Although Sturdivant and Wilhelm found that the price quoted to the various couples at a particular store did not differ significantly, they did report difference *across neighborhoods*, consistent with the historical narrative that the primary problem was forces that limited lower-income families to shopping in their local neighborhoods.[188] This cluster of economic and social forces created a situation where consumers were

[187] Frederick D. Sturdivant and Walter T. Wilhelm, *Poverty, Minorities, and Consumer Exploitation*, 49 SOCIAL SCIENCE QUARTERLY 643 (1968).

[188] They found that the three stores located in the heavily minority community of Watts consistently quoted higher prices for both cash and credit sales than Culver City or East Los Angeles. Watts, of course, was the site of some of the country's worst race-related rioting in 1965, resulting in 34 deaths and 1.032 injuries. Many public officials at the time pointed to the oppressive conditions of consumer financial services at the time as a major factor in sowing urban unrest. *See* HYMAN, *supra* note 154, at 173-75.

vulnerable to exploitation by retailers, but the NCCF concluded it was primarily a problem that resulted from limited income and market competition, not discrimination.

Based on the body of evidence available at that time, the NCCF concluded that it "did not find sufficient evidence to prove the hypothesis that there is racial discrimination in the granting of consumer credit."[189] The NCCF noted that based on its investigations, "Evidence does suggest that creditworthy consumers living in poverty areas have severe problems in obtaining credit, problems largely associated with the difficulties creditors have in collecting debts in certain areas of inner cities."[190] It was difficult to distinguish the impact of racial discrimination from other factors that are often found together with race, such as lower incomes, less wealth, and more unstable unemployment, or other factors aside from race.[191] As the NCCF concluded, "[T]he basic problem of providing credit to the poor is not a credit problem but an income and employment problem."[192] The NCCF concluded that the most direct and important step that could be taken to improve financial inclusion would be the removal of interest rate ceilings and other barriers to entry, which would prompt greater competition, more transparent pricing, and greater access to credit for all lower-income Americans, independent of race. But the NCCF also stressed that reforms to consumer financial protection law would be no silver bullet, as they would address primarily the symptoms of deeper social and economic challenges, not the causes.

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[189] NCCF Report, *supra* note 3, at 160.
[190] *Id.*
[191] *See* Walter E. Williams, *Why the Poor Pay More: An Alternative Explanation*, 52 SOCIAL SCIENCE QUARTERLY 375 (1973); *see also See* James J. Heckman, *Detecting Discrimination*, 12 J. OF ECON. PERSPECTIVES 101 (1998) (noting similar phenomenon with respect to employment studies).
[192] *Id.*

Today there remains stark differences in the financial conditions of minority households in America compared to White households. Black and Hispanic households are more likely to be unbanked than White households.[193] Although the unbanked rate has fallen steadily over the past several years as the economy has recovered from the Great Recession, it fell more rapidly than average for Black and Hispanic households.[194] Blacks and Hispanic households are less likely than White households to have a credit card. [195] Controlling for income bracket, Black and Hispanic consumers were more likely to be turned down when applying for credit than White applicants, although these gaps in approval rates are at least partially attributable to other factors related to creditworthiness that vary by race.[196] Overall, Black and Hispanic households are less likely than White households to report they are "doing okay" or living comfortably than White households.[197]

Minority households also have lower net wealth on average than White households.[198] From 2016-2019 the growth rate in net wealth was dramatically higher for Black (33 percent) and Hispanic families (65 percent) than White families (3 percent), after suffering larger than average drops in wealth during the Great Recession.[199] . Despite these recent gains, however, there remains a significant wealth gap between White and minority households on average. Homeownership rates are significantly higher

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[193] FEDERAL RESERVE BOARD, FINANCIAL WELL-BEING 2020, *supra* note 122, at 27-28.
[194] 2019 FDIC SURVEY, *supra* note 120, at 1.
[195] FEDERAL RESERVE BOARD, FINANCIAL WELL-BEING 2020, *supra* note 122, at 27-28.
[196] FEDERAL RESERVE BOARD, FINANCIAL WELL-BEING 2020, *supra* note 122. at 28.
[197] FEDERAL RESERVE BOARD, FINANCIAL WELL-BEING 2020, *supra* note 122, at 2.
[198] Neil Bhutta, Andrew C. Chang, Lisa J. Dettling, and Joanne W. Hsu, *Disparities in Wealth by Race and Ethnicity in the 2019 Survey of Consumer Finances*, FEDS NOTES, (Sept. 28, 2020).
[199] *Id.*

for Whites than for minorities and their home values are higher on average.[200] This difference in homeownership rates partly reflects the deeper intergenerational wealth of White families, as many young homeowners receive contributions from their parents to make their initial downpayment.[201] Black and Hispanic families are both less likely to have access to a retirement plan and, contingent on access, less likely to participate than White families. Black and Hispanic families, on average, have less money saved for short-term emergencies as well.[202]

The primary explanation for the persistence of the racial wealth gap is the racial income gap, which compounds the dynamics of wealth accumulation over time.[203] Differences in levels of educational attainment by racial and ethnic background contribute to these income differences. The role of intergenerational wealth transfers also contributes to a perpetuation of wealth inequality across generations in multiple ways, including enabling larger investments in higher education without incurring student loan debt, assistance in providing a downpayment for a house purchase, having family members with greater resources to fall back on in case of a financial emergency, and most obviously, larger inheritances and bequests.[204]

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[200] *Id.*
[201] *Id.* According to research by the Federal Reserve Board, 62 percent of renters state that the inability to afford a downpayment is their primary reason for renting compared to only 41 percent who state it is because they are unable to qualify for a mortgage. *See* FEDERAL RESERVE BOARD, REPORT ON ECONOMIC WELL-BEING, *supra* note 122, at 33.
[202] *See* Bhutta, et al., *Disparities in Wealth*, *supra* note 198.
[203] *See* Dionissi aliprantis and Daniel R. Carroll, *What is Behind the Persitence of the Racial Wealth Gap?*, FEDERAL RESERVE BANK OF CLEVELAND ECONOMIC COMMENTARY No. 201903 (Feb. 28, 2019), *available in* https://www.clevelandfed.org/newsroom-and-events/publications/economic-commentary/2019-economic-commentaries/ec-201903-what-is-behind-the-persistence-of-the-racial-wealth-gap.aspx.
[204] *See* Fabian T. Pfeiffer and Alexandra Killewald, *Multigenerational Correlations in Family Wealth*, 96 SOCIAL FORCES; A SCIENTIFIC MEDIUM OF SOCIAL STUDY AND INTERPRETATION 1411 (2017).

In addition, racial and ethnic differences in approaches to saving and investing might also have an effect on differential rates of wealth accumulation over time. Minority households historically have been more likely to invest in housing than financial investments, perhaps because of lower levels of risk tolerance than Whites.[205] Because the average return on financial investments exceeds that of housing over time, minorities' preference for investing in housing tends to increase the size of the wealth gap between minority and White households over time. Racial differences in educational levels may influence relative rates of wealth accumulation because more highly-educated individuals tend to be more confident and more knowledgeable about investment decisions and thus more likely to invest in higher-risk, higher-yield investments than less-educated individuals.[206] Minority and immigrant populations in the United States tend to be younger on average than Whites, thus it is important to control for age differentials in understanding racial income and wealth disparities. Because a variety of social, demographic, and educational factors appear to be tied in with decisions that affect income and wealth, more research on the potential relationship between racial and ethnic background on financial decisionmaking would be useful.

2 Unequal Treatment Based on Sex and Marital Status

Unequal treatment based on sex and marital status raised distinct issues from unequal treatment based on race. Discrimination based on race had ancient roots in legal and political injustice, which provoked upheaval and inspired reform beginning in the

[205] *See* Sharmila Choudhury, *Racial and Ethnic Differences in Wealth and Asset Choices*, 64 SOCIAL SECURITY BULLETIN No. 4 (2001/2002), *available in* https://www.ssa.gov/policy/docs/ssb/v64n4/v64n4p1.html; *see also* Sherman D. Hanna, Cong Want, and Yoonkung Yuh, *Racial/Ethnic Differences in High Return Investment Ownership: A Decomposition Analysys*, 21 J. OF FINANCIAL COUNSELING AND PLANNING 44 (2010).
[206] FEDERAL RESERVE BOARD, FINANCIAL WELL-BEING 2020, *supra* note 122, at 51.

1950s and 1960s, but the ordeal of unequal treatment was deeply intertwined with the challenges of poverty and residential segregation. The move to address issues of sex and marital status was primarily a political struggle, led by "affluent, mostly white women" many of whom were lawyers and other professionals."[207] In combination, the appeals for social justice and the rising economic power of the feminist movement became powerful arguments not just for equal treatment in credit granting but also for the eventual adoption of more objective determinations of creditworthiness based on credit reporting information rather than the subjective evaluations and potential biases of individual loan officers.

To a large extent, the inclusion issues confronting women were tied more to questions of marital status than sex. Based on testimony at its hearings, NCCF identified some evidence of unequal treatment based on sex, pointing to practices such as being unwilling to extend credit to a married woman in her own name, requiring women (but not men) to reapply for credit after getting married, and particular difficulty for separated, divorced, or widowed women in establishing credit.[208] As Hyman observes, "The existence or lack of individual credit histories for women drove many of the differences in credit access between single, married, and divorced women."[209]

Single women faced minimal systematic discriminatory barriers to credit access. As early as the 1920s, department stores had readily provided charge cards to single women who had sufficient income to qualify. Although they might face discrimination by sexist loan officers at particular firms, there were plenty of department stores and other

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[207] Hyman, *supra* note 154, at 193.
[208] NCCF REPORT, *supra* note 3, at 152-53.
[209] Hyman, *supra* note 154, at 193.

lenders who were happy to underwrite single women with sufficient income and character to qualify.

Problems began, however, when a single woman married, at which point her credit identity was merged into her husband's and her prior credit history disappeared. In many cases a married woman had to reapply for credit under her husband's name at department stores where they had previously been granted credit. Although this had minimal tangible impact on overall credit access (except when the wife earned higher income than her husband), it was highly humiliating, especially for affluent professional women who were simultaneously fighting for equality in the workplace. As Hyman observes, "For feminists, credit dependency on their husbands was a tangible reminder of how institutions defined them as an economic appendage of their husbands."[210] Access to credit in their own names was for professional married women, "not a strategy of survival but an expression of class privilege, economic independence, and pride."[211] The stated rationale for this practice was the fear by credit grantors that once married, women would "usually" soon have children and drop out of the workforce, thus relying on their husband's income and creditworthiness was considered a more reliable foundation for credit granting decisions than the wife's former income. In some instances, however, discrimination was more a reflection of the culture and practices of low-level loan officers than stated company policy.

For divorced and widowed women, however, the problems were economic, not just political and symbolic. Because their credit record when they were single was extinguished when they married, following divorce they appeared to have no credit

[210] *Id.*
[211] *Id.* at 203.

record at all. Moreover, if they stopped working while married they also little income to report. Prevailing underwriting standards also excluded alimony and child support payments as income, even though for many women with younger children those payments were their primary source of income.[212] Making matters worse, divorce was often correlated with a higher risk of default, and even though the woman was not granted credit in her own name she could be held jointly responsible for debts incurred while married.

Recognizing the economic opportunity presented by the growing economic clout of affluent professional women, many lenders began to alter their lending practices to tap this growing market. Indeed, some banks used feminist pitches to sell their financial services and take market share from discriminatory lenders. Politically influential feminists pushed for legislation that would require loans to be made on the basis of individual credit histories and other more-objective criteria rather than demographic stereotypes.

Today there are few systematic differences in the finances of women and men, and the differences seem related to factors other than bias in credit markets. According to a recent report by Experian, women's and men's FICO scores and levels of student loan debt are nearly identical.[213] Men overall carry 21.7% more debt than women overall and carry higher levels of mortgage, auto, personal loan, and credit card debt than women. Women have more open credit card accounts then men. Some research suggests that men

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[212] *Id.* at 198.
[213] *See* Brianna McGurran, *Women and Credit 2020: How History Shaped Today's Credit Landscape*, EXPERIAN.COM (Feb. 28, 2020), *available in* https://www.experian.com/blogs/ask-experian/women-and-credit/.

and women might have different attitudes toward debt, which might explain some of these differences in debt loads.[214]

Determining the extent and causes of wealth differences between men and women is difficult, largely because differences in wealth-building between married and unmarried households swamps differences between sexes within those categories.[215] Between never-married men and women, however, a significant wealth gap exists. This is largely because of an income gap between men and women that compounds into wealth differences over time.[216] In part, the lifetime income gap reflects lower rates of return for women's investments in education and their selections of less financially-remunerative occupations such as teaching and nursing.[217] Moreover, women tend to be more risk-averse in investment decisions[218] and express lower levels of financial literacy and confidence in their financial acumen,[219] leading them to prefer less-risky but less-rewarding investment strategies over time. As marriage and household formation takes place at steadily later ages today, and as an increasing number of Americans do not marry at all, understanding the nature and causes of wealth differences between men and women is an increasingly important topic of research.

3. Equal Credit Opportunity Act

The NCCF's hearings on equal credit access catalyzed efforts by politically-active feminists for legislation to prohibit the improper use of sex and marital status in credit

[214] *Id.*; *see also* Bijou Yang and David Lester, *Correlates of Credit Card Ownership in Men and Women*, 96 PSYCHOLOGICAL REPORTS 912 (2005).
[215] *See* Erin Ruel and Robert M. Hauser, *Explaining the Gender Wealth Gap*, 50 DEMOGRAPHY 1155 (2013). In fact, because women tend to marry men who are older than them at the time of marriage, marriage typically results in an immediate wealth increase for women.
[216] *Id.*
[217] *Id.*
[218] *Id.*
[219] FEDERAL RESERVE BOARD, REPORT ON ECONOMIC WELL-BEING, *supra* note 122, at 52.

decisions.[220] Starting at the state and local level, this effort culminated in the passage of the Equal Credit Opportunity Act a few years after the NCCF Report was produced.

Empirical studies suggested that at the time of ECOA's passage, there was minimal systematic evidence of widespread or systemic discrimination, and where harmful effects were found, they were generally small. Moreover, to the extent that discrimination was identified, it was more prevalent with respect to age and marital status than with respect to race or sex.[221] Evidence of discrimination on the basis of race was mixed, as some studies found evidence of disparate treatment while others did not.[222] With respect to evidence of differential treatment of men and women (controlling for marital status), the evidence suggested that lenders were just as likely to discriminate against men as against women. "In sum, [the studies] produced no rigorous statistical evidence of systematic discrimination against women before ECOA."[223]

The 1977 Consumer Credit Survey (now included in what is today known as the triennial Surveys of Consumer Finances, so hereinafter referred to as the 1977 SCF) sought to explore experience with unfair credit practices in consumer financial markets and the impact of the Equal Credit Opportunity Act of 1974 and 1976 shortly after passage of the new law.[224] Among other questions, the 1977 SCF reviewed responses from 2,563 respondents to the questions about whether consumers felt that they had "ever been treated unfairly in [their] credit transactions." Overall, the report found that although consumers had many complaints about unfair treatment by creditors, most of those were

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[220] Hyman, *supra* note 154, at 203.
[221] *See* discussion in DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at 441-446.
[222] *Id.* at 443-44.
[223] DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at 443.
[224] THOMAS A. DURKIN AND GREGORY E. ELLIEHAUSEN, 1977 CONSUMER CREDIT SURVEY (Board of Governors of the Federal Reserve System (Dec. 1978) (Chapters 6 and 7).

complaints about mistakes in billing, overly-aggressive collection tactics, credit denials, or other non-discriminatory claims of unfairness. "Responses concerning perceived unfair relationships between credit-granting and personal characteristics such as sex, marital status, age, and race were relatively uncommon."[225] In fact, of 2,563 respondents, only 37 complained that they felt that their personal characteristics had been unfairly considered in their credit experiences.[226] Most respondents felt that the most important criteria that creditors relied on in making decisions were factors such as credit history and income and not ECOA criteria. Of those who felt that personal characteristics had been unfairly used in their credit experiences, age and marital status were most frequently noted, "race and sex were mentioned by only a few."[227] Many minority consumers rarely applied for credit outside their local neighborhood, however, thus these findings might indicate self-selection by minority borrowers with respect to the institutions from which they sought credit.

Subsequent studies of the effects of ECOA's enactment found that it had limited direct effect. ECOA eliminated some disparate treatment based on age.[228] But ECOA, by itself, could not solve the complex problem of poor minorities trapped in the cycle of poverty and limited choice and competition that tied them to local retailers. As the NCCF concluded, "[T]he basic problem of providing credit to the poor is not a credit problem

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[225] DURKIN & ELLIEHAUSEN, 1977 CONSUMER CREDIT SURVEY, *supra* note **Error! Bookmark not defined.**, at 28.
[226] DURKIN & ELLIEHAUSEN, 1977 CONSUMER CREDIT SURVEY, *supra* note **Error! Bookmark not defined.**, at 34.
[227] DURKIN & ELLIEHAUSEN, 1977 CONSUMER CREDIT SURVEY, *supra* note **Error! Bookmark not defined.**, at 36. Whether the question was phrased as the "reason… given to respondents" for the denial or limitations or "perceptions" by the consumer, few respondents reported discrimination and those mentioning age or marital status was substantially higher than the number mentioning sex or race. *See id.* at 38, Tables 7-7, 7-8.
[228] DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at 444-448.

but an income and unemployment problem. The Commission urges treatment of the basic causes—income improvement programs, upgrading of neighborhoods, and education—in addition to efforts to make credit from legal sources more widely available."[229] Fifty years later, during a year in which urban unrest and national conversations about racial inequality have returned, the NCCF's assessment of the intractable nature of these deep economic challenges continues to resonate.

A primary effect of ECOA was acceleration in the substitution of credit scoring models in making credit determinations in place of the subjective assessments of low-level loan officers. As Hyman notes, ECOA led to the final replacement of the traditional "C's" of credit granting with a sixth "C"—the "computer."[230] As discussed above, the emergence of credit bureaus and adoption of credit scoring increased competition and dramatically expanded access to financial services for traditionally excluded groups. According to a 2007 report by the Federal Reserve Board, between 1983-2004 the prevalence of ownership of bank-type credit cards increased by over 25 percentage points across every racial and ethnic group and the gap between Blacks and Whites for all types of credit narrowed during that period.[231] According to research by the Federal Reserve, the use of credit scores in underwriting and pricing of consumer credit and mortgages does not create a disparate impact by race or gender, although it does have a limited

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[229] NCCF REPORT, *supra* note , at 16.
[230] *Id.* at 212.
[231] 44

disparate impact by age of lowering the credit scores of older individuals and increasing them for the young.[232]

With respect to women, studies indicated that ECOA might have eliminated some of the disparate negative treatment due to age and marital status that existed prior to ECOA but primarily accelerated many of already-occurring trends that were eliminating remaining barriers. Single women already largely had access to credit on risk-based terms. With respect to married women, ECOA likely hastened the ongoing market developments that were already under way for lenders to eliminate unprofitable discriminatory practices. ECOA likely had its greatest impact with respect to eliminating unfair discrimination against divorced and widowed women, although the tangible impact is difficult to measure the impact given that divorce itself increases the risk of default. By accelerating the adoption of objective criteria and credit-scoring models for credit underwriting, ECOA also eliminated the subjective assessments of loan officers who in the past might have had power to discriminate based on sexist sterotypes.

On the other hand, by excluding consideration of sex, ECOA might have had the unintended consequence of disadvantaging some female credit applicants because women often were better credit risks.[233] Moreover, other studies found that the sum effect of barring consideration of these variables and the potential information that they contained was to reduce the overall number of loans that were made and to increase the number of

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[232] *See* Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *Does Credit Scoring Produce a Disparate Impact?*, Federal Reserve Board Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affair, No. 2010-58 (Oct. 12, 2010).

[233] *See* DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at 447 (discussing GARY C. CHANDLER AND DAVID C. EWERT, DISCRIMINATION ON THE BASIS OF SEX UNDER THE EQUAL CREDIT OPPORTUNITY ACT (Purdue University Credit Research Center Working Paper No. 8, 1976).

bad loans made.[234] In addition, several studies found that ECOA and Regulation B increased costs for financial institutions.[235]

Despite ECOA's costs and unintended consequences at the time of implementation, it nevertheless has always held important symbolic value and has created a worthy standard and benchmark. On the other hand, some of the concerns that animated ECOA, such as irrational discrimination based on marital status, appear somewhat archaic today. In light of the changes in society and the economy in the 50 years since ECOA's enactment, the Taskforce recommends that Congress and regulators examine ECOA's provisions and implementing regulations and consider amending or eliminating certain limits that now seem archaic of provide minimal benefit relative to their costs.

At the same time, the passage of time has revealed certain new challenges that suggest the need for potential updating of ECOA. For example, the invention of in-vitro fertilization and other reproductive assistance technologies has given rise to financial products to fund those expensive procedures. But those seeking loans in those markets will be, by definition, women. In addition, changes in social values have suggested the propriety of extending ECOA's principles to new classes of Americans who originally were not included, such as those with disabilities. Although some issues involving disabilities and financial services are addressed by the Americans with Disabilities Act, submissions to the Taskforce indicate that there are additional issues related specifically to credit-granting and financial services that are not. Working-age disabled households

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234 DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at 447.
235 *See* DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at 448, n. 41 (citing studies).

are more likely to be unbanked than average.[236] The Taskforce believes Congress and regulators should examine ECOA and consider updating it to cover new situations and classes of covered persons while also identifying provisions that are now largely obsolete or ineffective, which could be deleted or modified.

B. Facially Neutral Laws with Disparate Effect

For most consumers in American history, facially neutral laws such as usury regulations have been the primary obstacle to greater financial inclusion. Complicated price control regulations have limited the ability of commercial banks to satisfy consumer demand while at the same time segmenting markets and limiting competition among products and providers. Still later, legal limits on competition in the form of "convenience and advantage" laws sometimes further limited entry and competition, especially with respect to lower-income and higher-risk borrowers.

Although not directly targeted at racial minorities, immigrants, younger consumers, and women, the adverse consequences of usury ceilings fell most heavily on members of those groups. As noted, prior to the effective deregulation of credit cards in the *Marquette* case, many banks viewed credit cards as money-losing courtesy products to be provided to wealthier professionals who were larger customers of the bank and who maintained larger deposits or used of other profitable bank products such as car loans or mortgages. Banks also made available to higher-income borrowers personal loans that were not available to the general public. Similarly, access to overdraft protection historically was seen as a "courtesy" product that banks extended to higher-income bank

[236] 2019 FDIC SURVEY, *supra* note 120, at 1-2. The percentage of disabled households with bank accounts remained about 18 percent from 2011-2017 but declined by two percentage points between 2017-2019. *Id.*

customers instead of declining payment of their transactions.[237] Meanwhile, lower-income families with less-established credit and fewer personal connections were left to struggle with retail store credit, personal finance company loans, and even illegal loan sharks. To the extent that certain sociodemographic groups, were overrepresented in these income and risk groups (such as immigrants and minorities), these facially-neutral regulations also had the incidental effect of disproportionately impacting those groups as well.

One way in which consumers and card issuers circumvented interest rate limits was by assessing an annual fee on credit cards or providing credit cards to those who maintained larger deposits, had personal connections, or were able to purchase other bank products. Even without any presence of racially discriminatory intent, all of these market adjustments tended to favor established, upper-class white men and to disadvantaged minorities, immigrants, and others who lacked the liquidity to pay higher annual fees or downpayments, or lacked the personal connections to gain preferential access to those products.

But usury regulation also might have facilitated intentional racial discrimination as well. First, one consequence of usury regulations was to create a shortage of access to financial services, or "rationing." Rationing occurs when demand for a good or service exceeds supply at the market price – that is, when people who can afford to pay the price are nonetheless unable to buy what they desire. The presence of excess demand at the regulated price forced lenders to select which applications would be accepted. As noted,

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[237] *See* Todd J. Zywicki, *The Economics and Regulation of Bank Overdraft Protection*, 69 WASH. & LEE L. REV. 1141 (2012).The advent of automated overdraft protection underwriting systems has enabled overdraft protection to be made available to virtually all customers who request it. *Id.*

this tended to lead to favor friends and family of bank officials, who were disproportionately white, upper-class men. But usury ceilings also reduced the cost of discriminating against applicants who the bank or its employees might disfavor for some discriminatory reason, such as race.[238]

This potential to discriminate on the basis of race was exacerbated because the impact of usury regulations in reducing competition through government-created barriers to entry. As discussed above, a major effect of usury regulations was to favor retail stores in the issuance of credit. As a result, competition in the issuance of consumer credit was constrained by the degree of competition in the retail market. Where retail competition was imperfect, the absence of meaningful competitive constraints on lender behavior could permit greater discrimination, either intentionally because of the difficulty faced by minority households of obtaining credit elsewhere, or merely in terms of a disparate impact by providing the retailer with some degree of market power that could be extracted by charging higher prices to all or some consumers.

Economists have argued that where discrimination exists, it tends to be more prevalent and persistent in monopolistic industries than in competitive industries.[239] This tendency may be particularly strong in markets characterized by government-created regulatory barriers to entry and competition.[240] Studies have found that during the long period of government prohibition on branch banking and other barriers to competition,

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[238] Although the Taskforce has been unable to locate any literature on this point that specifically analyzes consumer lending markets, minimum wage laws similarly creates labor market surpluses that enable discrimination by potential employers. *See* THOMAS SOWELL, MARKETS AND MINORITIES (1981).
[239] *See* GARY BECKER, THE ECONOMICS OF DISCRIMINATION 40, Table II (examining discrimination in labor markets).
[240] *See* Armen A. Alchian and Reuben A. Kessel, *Competition, Monopoly, and the Pursuit of Pecuniary Gain*, *in* ASPECTS OF LABOR ECONOMICS 157 (National Bureau of Economic Research 1962), *available in* https://www.nber.org/chapters/c0605.pdf.

banks acted much like monopolistic enterprises in other industries, performing at suboptimal levels of efficiency and dissipating profits through inflated employee salaries and staffing, shorter working hours (i.e., "banker's hours"), and other perquisites. Deregulation of entry of the banking industry propelled greater competition and elimination of many markets previously protected from competition.[241]

C. Competition and Discrimination

Discriminatory outcomes are less likely in competitive markets. With respect to bank accounts, for example, Celerier and Matray found that elimination of barriers to interstate branch banking resulted in an increase in access to bank accounts for low-income households in general, but the effect was particularly large for Black households living in states with a history of discrimination.[242]

Disparities in lending terms and access are more likely to occur in less-competitive markets, and increased competition in consumer credit markets reduces disparities in access to and the terms of consumer financial products.[243] For example, one recent study concluded that Latino and Black borrowers paid higher mortgage prices and were more likely to have their loan applications rejected in less competitive markets and increased competition, in this case the entry of FinTech mortgage lenders into the market,

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241 Consistent with the prediction from other labor markets, increased competition in banking markets through relaxation of government barriers to entry reduced prior disparities between men and women employees in pay and promotion. *See* Sandra E. Black and Philip E. Strahan, *The Division of Spoils: Rent-Sharing and Discrimination in a Regulated Industry*, 91 AM, ECON. REV. 814 (2001).
242 *See* Celerier & Matray, *supra* note 112.
243 *See* James A. Berkovec, Glenn B. Canner, Stuart A. Gabriel, and Timothy H. Hannan, *Discrimination, Competition, and Loan Performance in FHA Mortgage Lending*, 80(2) REV. ECON. & STATS. 241 (1998). These studies are discussed extensively in Chapter 8 and are only summarized here. Several of these studies characterize these differences as reflecting "discrimination" but none of them provide evidence of intentional discrimination. Instead, they provide evidence with respect to disparities in credit access and terms which may or may not support an inference of discrimination.

reduced or eliminated price disparities in the market.[244] Thus Butler, et al., reported evidence that reinforces findings of other studies that found that disparate pricing for minorities was more common in markets where auto dealers faced less competition from banks.[245] They also found no evidence of disparate treatment in applications for credit card loans for the same group of minority borrowers who received disparate pricing in the context of auto loans. This finding is consistent with the observation made above that loans made in a face-to-face context are more prone to discriminatory effect than those made through an algorithmic process.[246] Lending on a face-to-face basis instead of impersonal, algorithmic-type lending may also be more prone to disparities in lending terms between different demographic groups.

Notably, however, while some studies identify disparities between different borrowers with different demographic characteristics, they have not established that markets with smaller disparities in prices actually result in *lower* average prices for consumers or lower prices for most consumers. For example, Bartlett, et al., noted that the greater likelihood of finding disparities in lending terms in face-to-face markets could result either from an increased risk of discrimination *or* a greater ability of lenders to "profile" borrowers who are less likely to shop for competing offers.[247]

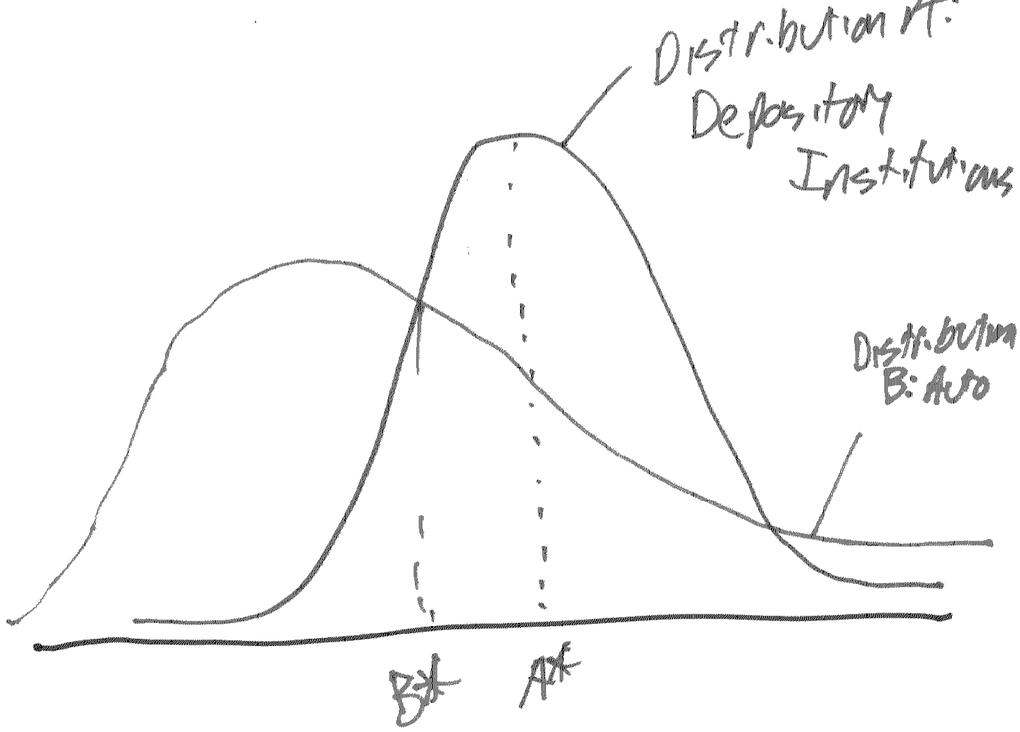
Consider a hypothetical market with two different types of providers with a bell curve that describes the distribution of prices in a given market. Distribution A could be narrowly distributed with a high concentration of transactions conducted around the

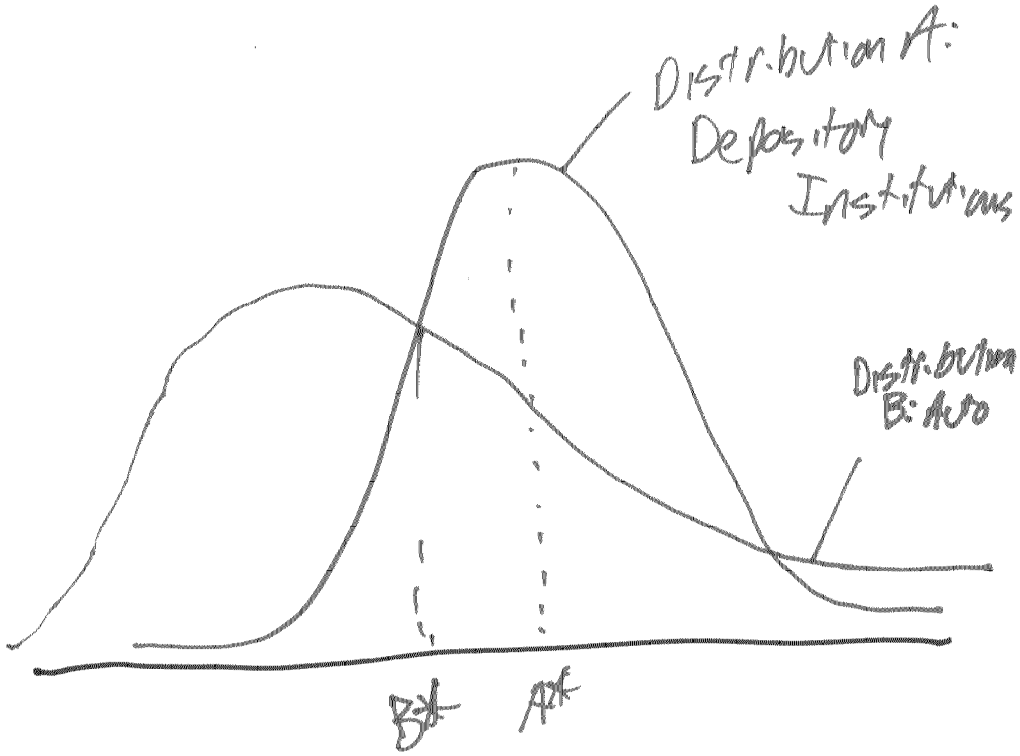
[244] *See* Robert Bartlett, Adair Morse, Richard Stanton, and Nancy Wallace, *Consumer-Lending Discrimination in the Fintech Era*, NBER Working Paper No. 25943 (June 2019), *available in* https://www8.gsb.columbia.edu/faculty-research/sites/faculty-research/files/finance/Finance%20Seminar/Fall%202016/Unbanked_October2016.pdf.
[245] *See* Butler, et al., *supra* note 254, at 19.
[246] *See* Butler, et al., *supra* note 254, at 18.
[247] *See id.*

distribution average, indicated as A*, and very thin price distributions at the tail. Distribution B, by contrast, could have fewer transactions close to the average price, indicated as B*, but a larger and thicker distribution of prices at the tails, i.e., with fewer consumers at the average and a larger number of consumers at prices above and below average.[248] This would be the case if, for instance, prices are set through haggling, and some consumers are savvy negotiators and aggressive shoppers who can drive a particularly good bargain while others are poor negotiators and low-shoppers who end up being charged a higher than average price. Overall, median and average prices for consumers under these hypothetical distributions could be lower in hypothetical market B than market A, even if a larger number of consumers receive unusually high prices in market B.

Figure 10-2: Possible Distributions of Credit Terms In Different Market Settings

[248] For illustration purposes here it is irrelevant whether the distribution median or average is considered.


Distribution A:
Depository
Institutions
Distribution
B: Auto
B*
A*



Economists have described the mortgage market in terms consistent with these potential price distributions in contrasting the pricing of depository institutions with mortgage brokers.[249] Depository institutions, such as banks and credit unions, typically have pricing distributions that look like Distribution A with limited pricing discretion and limited pricing disparities among consumers. They found that mortgage brokers, by contrast, had much greater discretion in pricing decisions and shopped more aggressively for lower cost of funds that could be passed on to consumers. As result, mortgage brokers

[249] *See* Amany El Anshasy, Gregory Elliehausen, and Yoshiaki Shimazaki, *The Pricing of Subprime Mortgages by Mortgage Brokers and Lenders* (June 2006), *available in* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1717013.

on average offered lower prices for subprime mortgages than did direct lenders, with a majority of consumers receiving prices below that offered by direct lenders. Although most borrowers received lower prices from mortgage brokers than direct lenders, some consumers received higher prices from brokers. The greater variance in the distribution of pricing by mortgage brokers meant that some borrowers paid higher prices than the average at direct lenders, which charged higher prices on average but exhibited lower variances in pricing.

The CFPB's experience with enforcement actions against loans made by auto dealers potentially illustrates these tradeoffs between lower price dispersion but higher overall prices.[250] The CFPB was concerned about a perceived inequality in prices charged between minority and non-minority car loans financed through dealers. Auto loans by banks today largely rest on automated underwriting models (at least for new cars) and result in effectively posted pricing that varies little from borrower to borrower. Financing through an auto dealer, by contrast, comes about through a potentially extended period of face-to-face negotiations where the dealer shops for financing from various financial institutions and negotiates with the consumer over the final financing price. In at least some instances, especially for consumers with poor credit, the dealer might also have to engage in extensive search and negotiation efforts of its own to find a financial institution to finance the transaction.

Moreover, auto dealers routinely use promotional financing offers, whether formal or informal, to "move" certain inventory. In some instances, instead of reducing

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[250] For example, if the government created and enforced a perfectly coordinated cartel among competitors in an industry, it could ensure there would be no price dispersion for any reason, and a few consumers might even get a lower price than they otherwise would, but consumers would worse off from the overall increase in prices.

the sticker price on a car, a dealer might prefer to subsidize the purchase price through discounted financing terms, thereby effectively reducing the final price without reducing the transaction price. The presence of these promotional financing offers, as with end-of-season department store clothing sales, will invariably result in higher price dispersion among consumers—but likely also result in lower average prices overall for consumers.[251]

Available evidence is very thin, but there is reason to believe that the CFPB's enforcement actions against auto dealers for alleged violations of the Equal Credit Opportunity Act might have had this effect of reducing pricing variance while increasing average prices. Notably, the CFPB's enforcement actions in this area typically provided no evidence of intentional discrimination, they simply alleged statistical disparities in pricing between the terms of the loans to minority borrowers versus those of similarly-situated white borrowers and attributed it to racial discrimination.[252] Nor did the CFPB's enforcement action control for the numerous factors that are known to affect the pricing of an auto dealer loan, including credit risk, new/used status of the car, or loan term.[253]

The only alleged basis for pricing disparity was the practice by auto finance companies of permitting auto dealers to "markup" the prices of loans interest rate above the financing company's buy rate and then compensating the dealer for the increased revenue. Under the settlements entered into between the CFPB and the various targets of

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[251] Thus, if a dealer has excess supply of, say, sedans, the dealer might advertise a promotional financing offer on those vehicles or simply informally negotiate more flexibly if a consumer is interested in buying a sedan. By contrast, if a dealer has limited supply of, say, pickup trucks, the dealer might be less flexible on both purchase price and financing..

[252] *See* John L. Ropiequet, *What is the Future of Fair Lending Following* Inclusive Communities? 34(11) BANKING & FIN. SERVS. POL'Y REP. 9, 15 (2015).

[253] *See* REPORT PREPARED BY THE REPUBLICAN STAFF OF THE UNITED STATES HOUSE OF REPRESENTATIVES, UNSAFE AT ANY BUREAUCRACY: CFPB JUNK SCIENCE AND INDIRECT AUTO LENDING 38 (Nov. 24, 2015).

its enforcement actions, the standard remedy was to force auto finance companies to adopt flat-rate markups on their issued buy rate, rather than permitting negotiated markup rates.

According to Butler, et al., those enforcement actions might have narrowed price disparities between White borrowers on one hand and Black and Hispanic borrowers on the other in the prices provided to consumers who obtained their financing from auto dealers.[254] Although the authors control for credit score in their analysis, they did not control for other characteristics of the loan or of consumers that also impact the final price charged on the loan, such as income, debt-to-income ratio, loan term, downpayment size, trade-in, vehicle type (model and whether new or used), and whether the prospective purchaser already has an existing preapproved financing offer from another financing source.[255]

Moreover, any reduction in pricing discretion and price disparities between different classifications of borrowers might have come at the cost of higher average prices. According to a report in the *Wall Street Journal*, when auto finance companies adopted policies that reduced discretion in dealer markups, which consumers can effectively negotiate with dealers, finance companies simultaneously also "raised a less-

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[254] *See* Alexander W. Butler, Erik J. Mayer, and James P. Weston, *Racial Discrimination in the Auto Loan Market*, www.SSRN.com (June 2020), *available in* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3301009. As with other earlier references, the title of this paper is misleading, as the authors simply provide evidence of pricing disparities in auto lending markets, not evidence of discrimination.

[255] *See 6 Factors that Affect Car Loan Rates*, WWW.IDRIVESAFELY.COM, *available in* https://www.idrivesafely.com/defensive-driving/trending/6-factors-affect-car-loan-rates; Rod Looker, *5 Factors That Affect Your Auto Loan*, WWW.ROADLOANS.COM (Feb. 2, 2020), *available in* https://roadloans.com/blog/5-factors-that-affect-your-auto-loan; Paul Sperry, *Bank CEO Reveals How Obama Administration Shook Him Down*, N.Y. POST (Feb. 21, 2016), *available in* https://nypost.com/2016/02/21/bank-ceo-reveals-how-obama-administration-shook-him-down/ (statement by former Ally CEO Michael Carpenter that pricing disparities between different races on Ally finance loans were largely explained by credit differences, vehicle type purchases, trade-ins, or the size of downpayments).

negotiable component of its rates," which the reporters characterized as "a move that could increase consumers' overall loan costs."[256] The report concluded that while under the prior regime Black, Hispanic, and Asian borrowers were charged approximately 20-30 basis points higher rates than White borrowers, following the CFPB's enforcement action (and the accompanying offsetting price adjustments by finance companies), most purchasers were paying rates that were "at least" 110 basis points higher than before the CFPB's enforcement activities began. Although assessing the validity of the theory would require more rigorous statistical analysis, this episode raises the possibility that by reducing pricing discretion by auto dealer on markups, the CFPB's enforcement actions reduced price disparities between different groups of consumers but at the cost of raising prices on average for *all* consumers overall—including potentially minorities who were the intended beneficiaries of the CFPB's enforcement actions.[257]

D. The Effect of Historic Discriminatory Government Laws and Policies

Although effects of discrimination are generally muted in competitive markets, they can be pervasive and durable in less-competitive markets.[258] This can especially be the case when the dominant player in the market is a government entity, especially the United States government. Such is the case with the extended period of discriminatory

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[256] *See* AnnaMaria Andriotis and Gautham Nagesh, *Crackdown on Racial Bias Could Boost Drivers' Costs for Auto Loans*, WALL ST. J. (Aug. 31, 2015), *available in* https://www.wsj.com/articles/crackdown-on-racial-bias-could-boost-drivers-costs-for-auto-loans-1441038864.

[257] *See* Todd J. Zywicki, *The Dodd-Frank Act Five Years Later: Are We More Stable?*, 43 CAPCO J. OF FIN. TRANSFORMATION 62, 69 (May, 2016). Although Butler, et al., conclude that the CFPB's enforcement actions reduced price disparities between White and minority borrowers, they do not establish whether the narrowing of difference resulted from reducing the rates charged to minority borrowers as opposed to raising the rates charged to all borrowers or White borrowers specifically to match that of minority borrowers.

[258] Consistent with this observation, there are numerous studies of discrimination in residential mortgage practices in the United States but relatively few in non-mortgage markets. And as discussed above, those studies show mixed effects as to the prevalence of discrimination in non-mortgage markets.

policies implemented and enforced by the United States government beginning during the New Deal and extending into the post-War era and shaping the residential patterns of the emerging suburbs. Vestiges of these discriminatory policies persist today in lower wealth holdings among different demographic groups and residential patterns.

Most well-known of the federal government's discriminatory policies was the notorious practice of "redlining" imposed by the Home Owners Loan Corporation ("HOLC") during the New Deal.[259] The HOLC was established in 1933 to deal with the problem of rising home foreclosures during the Great Depression.[260] The term "redlining" arose from HOLC's practice of creating color-coded maps that indicated the relative desirability of different neighborhoods from the perspective of appraisals. Often these evaluations were based on the race of the residents rather than some other criterion such as income. For example, neighborhoods colored green were those were most desirable rising neighborhoods, meaning "new, homogenous, and in demand as residential locations in good times and bad," consisting predominantly of "American business and professional men." Down through the tiers went the classification through blue-colored (stable neighborhoods) and yellow-colored neighborhoods ("definitely declining"), until the fourth category—colored red—was reached. Neighborhoods colored red were considered those "in which the things taking place in [yellow] areas have already happened."[261] In making these classifications, HOLC would often rely on the racial

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[259] There were many racist elements, both *de jure* and *de facto*, of the New Deal. The Taskforce's narrow focus on the problems related to financial inclusion and government-sponsored discrimination is not intended to discount the adverse effects of many of those other racist New Deal policies on Black families and others.

[260] *See* Charles Lewis Nier, III, *The Shadow of Credit: The Historical Origins of Racial Predatory Lending and Its Impact Upon African American Wealth Accumulation*, 11 U. PA. J. L. & SOCIAL CHANGE 131, 175 (2007-2008).

[261] Nier, *supra* note 260, at 177.

composition of the neighborhood. As a result, most neighborhoods with heavy minority populations, including in many large northern cities, were coded as areas that were declining or had already declined.[262]

Despite the racist characteristics of the federal government's administration of the HOLC program through redlining, market incentives reduced its impact in restricting housing credit to Black borrowers.[263] One statistical analysis of mortgage lending patterns during the New Deal in Philadelphia concluded that private lenders continued to make mortgage loans in redlined areas notwithstanding the federal government's racist policies. As Hilliard summarizes her empirical analysis, "These [regression] results confirm that lenders did not categorically redline areas that HOLC colored red. Households in all parts of the five sample areas succeeded in securing mortgages." She continues, "[T]he analysis does indicate that there was a significant amount of conventional mortgage activity in all parts of the city involving many different types of lenders. While these different types of lenders showed preferences for certain areas and types of properties, none categorically refused to lend to all red areas."[264] Indeed, it is unclear to extent to which private lenders were even aware of the HOLC's lending maps much less used them in their loan decisions.[265]

While HOLC made many loans in minority neighborhoods coded yellow and red, itrefrained from making loans to Black families seeking to integrate a predominantly

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[262] "For example, in Detroit, every neighborhood with any degree of African American population was rated 'D' or 'hazardous' by federal appraisers. Also, any location subject to 'infiltration' by 'an undesirable population' received a 'D' rating." Nier, *supra* note 260, at 179.
[263] *See* Amy E. Hillier, *Redlining and the Home Owners' Loan Corporation*, 29 J. of URBAN HIST. 394 (2003).
[264] Hillier, *supra* note, at 409. She found that loans in redlined areas had interest rates that were slightly higher than elsewhere but it is possible that could be explained by differences in risk. *Id.*
[265] *Id.*

White neighborhood.[266] "While HOLC does not appear to have avoided making loans to African Americans, Jews, and immigrants or to neighborhoods with concentrations of African Americans and immigrants, the agency did avoid making loans to African Americans in white areas."[267] Thus, the primary impact of the federal government's policy in this area appears to have been to maintain patterns of residential segregation, not to directly interfere with access to mortgage credit for Black households at least during this period.

The detrimental racial impact of federal governmental policies became more pronounced as racist New Deal housing policies shaped migration patterns to the suburbs, especially in the post-War era. The Federal Housing Administration ("FHA") was formed in 1937 to carry forward HOLC's initial emergency efforts to save homes from foreclosure into a government program to subsidize home ownership.[268] FHA's primary role was to insure private lenders against potential losses from mortgage lending and thereby to make possible lending with low downpayments or longer loan terms (with lower monthly payments) than might otherwise be economically prudent.[269] To some extent, FHA's racially discriminatory effects arose from facially neutral policies: for example, FHA preferred to support new construction of detached single-family homes in suburban neighborhoods instead of urban homeownership, which mirrored the growing tendency of White families to relocate to the suburbs. On the other, hand, FHA also

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[266] Amy E. Hillier, *Who Received Loans? Home Owners' Loan Corporation Lending and Discrimination in Philadelphia in the 1930s*, 2 J OF PLANNING HIST. 3, 19 (2003).
[267] Hillier, *supra* note 266, at 19.
[268] *See* Nier, *supra* note 260, at 180-81.
[269] *See* Nier, *supra* note 260, at 180-81; *see also* Kevin Fox Gotham, *Racialization and the State: The Housing Act of 1934 and the Creation of the Federal Housing Administration*, 43 SOCIOLOGICAL PERSPECTIVES 291 (2000); RICHARD ROTHSTEIN, THE COLOR OF LAW: A FORGOTTEN HISTORY OF HOW OUR GOVERNMENT SEGREGATED AMERICA (2018).

expressly considered the racial homogeneity and composition of a neighborhood, even endorsing racially-restrictive covenants to preserve racial "harmony" and the overall stability of the neighborhood.[270] In fact, in subsidizing the development of the famous Levittown suburb, the FHA required as a condition for subsidizing the development that no homes could be sold to Black buyers and that each home in the development would contain a racially-restrictive resale covenant.[271] According to the FHA's underwriting manual at the time, "if a neighborhood is to retain stability, it is necessary that properties shall continue to be occupied by the same social and racial classes."[272] This heavy governmental intervention in a discriminatory fashion eventually shaped private mortgage lending policy more generally, as private lenders dramatically reduced their level of mortgage lending to Black borrowers.[273] As Richard Rothstein has observed, "[W]ithout federal policy designed explicitly with racial explicit intent to segregate every metropolitan area in this country,… private factors [such as private prejudice or real estate agent steering] would not have been able to successfully segregate their communities."[274]

These discriminatory FHA policies historically appear to have contributed to lower home ownership rates among Black families by either excluding them from mortgages entirely or by forcing them to turn to more-expensive alternatives. As a result, government-created barriers to homeownership by Black families have almost certainly

[270] Nier, *supra* note 260, at 183
[271] ROTHSTEIN, *supra* note 269.
[272] *See* KENNETH T. JACKSON, CRABGRASS FRONTIER: THE SUBURBANIZATION OF THE UNITED STATES 208 (1985) (citing U.S. FED. HOUS. ADMIN., UNDERWRITING MANUAL § 1301 (rev. Jan. 1, 1947).
[273] Nier, *supra* note 260, at 185.
[274] *See A Forgotten History of How the U.S. Government Segregated America*, FRESH AIR (May 3, 2017), *available in* https://www.npr.org/transcripts/526655831.

contributed to the continuing wealth gap between White and Black families.[275] For many middle-class and working-class families, home ownership represents a significant portion of their household wealth.[276] Subsequently, the United States Supreme Court invalidated racially-exclusionary covenants in housing[277] and Congress adopted the Fair Housing Act in 1968 that formally did away with the federal government's original discriminatory lending mandates.[278] Although these laws eliminated government-mandated segregation they did not eradicate its historical legacy in housing or housing finance.

Whatever the continued effect of these home ownership limits on current home ownership rates, it appears that to a large extent government-sponsored discrimination has been eliminated. For example, a 1996 study found that Black mortgage borrowers were more likely to default than non-minority borrowers on Federal Housing Administration (FHA) loans, which suggests that at that time there was a tendency to stretch credit acceptability by FHA at the time and not substantial levels of racial bias in its mortgage lending.[279]

VI. Paths Toward Greater Inclusion

The Taskforce believes that all policymakers, including Congress, the CFPB, the Department of the Treasury, and various financial regulatory agencies such as the OCC,

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[275] *See* Lisa J. Detting, Joanne W. Hsu, Lindsay Jacobs, Kevin B. Moore, and Jeffrey P. Thompson, *Recent Trends in Wealth-Holding by Race and Ethnicity: Evidence from the Survey of Consumer Finances*, FEDS NOTES (Sept. 27, 2017).

[276] 32 percent of household wealth for White families and 37 percent of wealth for Black families is in housing. *Id.* at Table 1. 73 percent of White families are home owners compared to 45 percent of Black families. Average net housing wealth is more than twice as large for White families as for Black.

[277] Shelley v. Kraemer, 334 U.S. 1 (1948).

[278] 42. U.S.C. § 3601, *et seq.*

[279] *See* James A. Berkovec, Glenn B. Canner, Suart A. Gabriel, and Timothy H. Hannan, *Mortgage Discrimination and FHA Loan Performance*, 2(1) CITYSCAPE: A JOURNAL OF POLICY DEVELOPMENT AND RESEARCH 9 (Feb. 1996), *available in* https://www.huduser.gov/Periodicals/CITYSCPE/VOL2NUM1/berkovec.pdf.

FDIC, NCUA, and others, should prioritize greater levels of financial inclusion and access to mainstream financial products. Consumer choice should be the guiding principle—those who seek, and qualify for, greater access to mainstream financial products should have access to those products as desired. Policy makers should be especially skeptical of claims rooted in purported "consumer protection" concerns that at best reflect misplaced paternalistic concerns that fail to recognize the dignity and autonomy of those who are more aware of their own particular needs and circumstances of time and place in selecting and using products and services they believe will benefit themselves and their families. At worst, these expressed concerns are often little more than insincere efforts by powerful interest groups to stifle competition and innovation under the guise of consumer protection concerns.[280]

The problem of inadequate financial inclusion is one of inadequate choices and competition that interferes with the ability of certain consumers to access the products and services in a marketplace free from bad practices by providers (such as fraud and unfairness) but also free from regulatory distortions that unfairly tilt the market and advantage some providers over others or some consumers over others. Laws, regulations, and other policies that deprive consumers of choices, especially those who already have the fewest choices available, should be viewed as presumptively unlikely to make those consumers better off. As noted above, decades of historical experience and economic analysis with usury ceilings has demonstrated repeatedly that although purportedly intended to help lower-income and traditionally excluded consumers, those laws have

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[280] *See, e.g.*, James Cooper and Todd Zywicki, *A Chip Off the Old Block or a New Direction for Payment Card Security? The Law and Economics of the U.S. Transition to EMV*, 2018 MICH. ST. L. REV. 869, 917-922 (2018).

invariably harmed the very class of consumers who the laws are purportedly intended to help. Although delivering less than purported in the way of benefit to lower-income consumers, however, usury ceilings, especially where tailored to particular product markets, and accompanying barriers to entry have often been very beneficial to certain interest groups in segmenting markets and protecting them from competition.

As a result, the Taskforce urges policymakers to carefully scrutinize all laws and regulations to insure that they *actually* will benefit *all* consumers, not merely the well-off, and that they promote competition and consumer choice, especially for those who otherwise have the fewest options. Policymakers should be especially skeptical of laws and regulations that control prices, especially those that interfere with risk-based pricing terms, and that erect barriers to entry and competition. Regulations that restrict prices, choice, and competition in the name of consumer protection should be scrutinized under rigorous and searching cost-benefit analysis to ensure that depriving consumers of choices and replacing voluntarily-determined prices and terms with politically-dictated prices and terms will benefit for consumers, especially the least well-off.

This section of the report provides an overview of some current laws and regulations that the Taskforce believes provide potential barriers to greater financial inclusion. This is not intended as an exclusive list but to point out some particular areas of concern and to provide guidance to the CFPB and other policy-makers in examining existing regulations to ensure that they do not unduly interfere with efficient levels of financial inclusion. Second, the report goes beyond suggestions for review of current regulations that interfere with financial inclusion and to a discussion of affirmative proposals that can further the goal of financial inclusion.

A. Removing Regulatory Barriers to Inclusion

We begin by identifying existing regulatory barriers to financial inclusion. For purposes of efficiency we will not reiterate concern about usury ceilings in states that retain them in whole or in part. The Taskforce is unable to identify any tangible economic net benefit from the continuation of usury ceilings, especially for traditionally excluded consumers. Those states that continue to impose usury ceilings are urged to review their real-world effects and to modify them as appropriate.

1. Debit Card Interchange Price Controls

Section 1075 of Dodd-Frank, entitled "Reasonable Fees and Rules for Payment Card Transactions," imposed price controls on the permissible prices that debit card issuers can charge for interchange fees on debit cards.[281] After a comprehensive view of the literature, the Taskforce has concluded that the enactment of Section 1075 and its implementing regulations has produced higher bank fees, especially for lower-income consumers, and increased the number of Americans without a bank account, with minimal evidence that those increased bank fees have been offset by reductions in retail or other prices to consumers.

Payment card networks have two basic structures, what are referred to as either a three-party or four-party system.[282] A three-party system, such as American Express or Discover, is one in which the card issuer deals directly with both the consumer and the merchant. The network issues the card, processes the payment transfers, and operates the

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[281] This provision of Dodd-Frank is sometimes referred to as the "Durbin Amendment," after its primary congressional sponsor, Senator Richard Durbin.
[282] *See* Todd J. Zywicki, *The Economics of Payment Card Interchange Fees and the Limits of Regulation*, George Mason Law & Economics Research Paper No. 10-26 (June 2, 2010), *available in* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1624002.

credit underwriting and processing function with respect to consumers. In four-party system such as the Visa or MasterCard networks, by contrast, consumers and merchants do not deal directly with the network. Instead, the relationship is intermediated through financial institutions—the consumer's bank that issues the card and services the consumer's account (called the "issuing bank" or "issuer") and the merchant's bank (called the "acquiring bank" or "acquirer"). The role of the network, is primarily limited to serving as a bridge between the issuing bank and the acquiring bank and providing the mechanisms and rules for which transactions take place.[283]

Regardless of whether a given network is a three-party of four-party system, operating that system entails costs. In a three-party system, the costs are borne directly by the network, which is responsible for attracting and retaining customers (both merchant and consumer), processing payments, underwriting lending operations, preventing fraud, resolving disputes, and issuing cards and the like. In a four-party system, the operation of the system is more decentralized. Acquiring banks deal directly with merchants and issuing banks deal directly with consumers. To cover some of those costs, the acquirer charges fees directly to the merchant and the issuer charges fees directly to the consumer, such as annual fees, finance charges, or other fees. The role of the network is to provide a platform to create a contractual relationship that will enable the issuing and acquiring banks to deal effectively with each other and to transfer money from consumers, via their banks, to merchants, via their banks.

[283] For a more detailed explanation of the operation of payment card systems, *see* Zywicki, *supra* note 282, at 27-30.

Payment card systems are a prominent example of what has come to be known as a "two-sided market."[284] Two-sided markets are ubiquitous in the economy, describing economic enterprises as diverse as shopping malls, internet search engines, dating services, social networking websites, app stores, and newspapers. The distinguishing characteristic of a two-sided market is that the consumer does not interact directly with the merchant, but instead transacts through an intermediary. The intermediary provides the platform through which this interaction can occur more easily. Thus, for example, the primary economic model of a newspaper is to connect advertisers with consumers through the platform of the newspaper and the primary economic foundation of a search engine is largely the same. Each intermediary provides content that attracts consumers – articles in newspapers or search results for search engines – and such content imposes costs for the network that must be recovered from one of the participants in the platform, either the merchant or the consumer. As the Supreme Court wrote in *Ohio v. American Express*:

> By providing these services to cardholders and merchants, credit-card companies bring these parties together, and therefore operate what economists call a "two-sided platform." As the name implies, a two-sided platform offers different products or services to two different groups who both depend on the platform to intermediate between them."… For credit cards, that interaction is a transaction…. The key feature of transaction platforms is that they cannot make a sale to one side of the platform without simultaneously making a sale to the other.[285]

[284] *See* Zywicki, *supra* note 282; *see also* Jean-Charles Rochet & Jean Tirole, *Two-Sided Markets: A Progress Report*, 37 RAND J. ECON. 645 (2006).
[285] *Ohio v. American Express Co.*, 585 U.S. __ , slip op. at 2 (2018).

A logical corollary in the case of a two-sided market is that the costs of the system arise from the *joint* interaction of the cardholder and merchant with the network.[286] If a cardholder wants to use a form of payment that the merchant does not want to accept (such as Bitcoin, for example), then no cost is incurred. And if the merchant accepts a form of payment that the consumer does not want to use (say a check) then no cost is incurred. Costs are only incurred if *both* the consumer and merchant choose to interact through the platform. Thus, because these costs arise from the joint interaction, there is no "natural" way to allocate the costs associated with the platform supplying the transaction.[287]

More fundamental, the costs of operating the platform must come from merchants and consumers.[288] Costs that are not borne by consumers must be covered by merchants and vice-versa. Economic theory predicts that the owner of the platform will operate the platform, and allocate the costs accordingly, so as to maximize the value of the platform to its users. This requires the network to set the respective prices it charges for participants on each side of the market to use the platform. If the network sets the price too high for consumers, then they will be unwilling to use the network; similarly, if the network sets the price too high for merchants they will not be willing to use the system.

For this result to occur, it is commonplace that one side of the platform will "subsidize" platform usage by the other side, typically taking the form of merchants

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[286] *See* William F. Baxter, *Bank Interchange of Transactional Paper: Legal and Economic Perspectives*, 26 J. L. & ECON. 541 (1983).
[287] *See* Ronald H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960).
[288] *See* Zywicki, Interchange, *supra* note 282, at 31-32.

subsidizing usage of the platform by consumers.[289] It also is not uncommon for there to be not only cross-subsidies *across* the two sides of the market (from merchants to consumers) but *among* the participants on one side of the market. In general, however, the costs of operating the two-sided market tend to fall on the party that is the more "inelastic" demander of the platform's services, advertisers in the case of newspapers and merchants in the case of payment cards.[290]

The "interchange" fee in a network underlying use of payment devices like credit or debit cards is the fundamental price mechanism used within the four-party network system to allocate the costs among merchants and consumers.[291] The interchange fee is the element of the transaction that is remitted by the merchant's bank to the issuing bank when the transaction is made. The merchant discount fee also includes a fee the merchant pays its acquiring bank to process transactions, as well as a small amount to the network itself. For credit cards, the merchant discount fee on ranges from about 1.5 percent to 2.9 percent for swiped transactions and higher for keyed-in transactions.[292] The majority of the merchant discount is the interchange fee remitted to the issuing bank, which ranges from 1.4 percent to 3.4 percent and averages approximately 2.2 percent.[293] This

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[289] Thus, although advertisers draw little benefit from the news provided by a newspaper (other than in their employees' status as fellow readers), advertising expenditures cover much of the costs of providing that news function well beyond the costs of producing their particular advertisements. This subsidy is provided voluntarily by advertisers in order to persuade potential customers to read the newspaper and thereby to see the advertisements by generating higher circulation.

[290] *See* Zywicki, Interchange, *supra* note 282, at 33.

[291] Three-party systems essentially have the equivalent of an interchange fee as well, it just is not a separate component of the merchant discount fee.

[292] *See* Randy Hayashi, *What are the Average Credit Card Processing Fees that Merchants Pay?*, PAYMENTDEPOT.COM (Jan. 24, 2020), *available in* https://paymentdepot.com/blog/average-credit-card-processing-fees/#:~:text=As%20mentioned%20earlier%2C%20merchants%20typically,transactions%20also%20have%20higher%20fees.

[293] *See* Wayne Brough, *Would a Shift from Cards to Cash Really Help Retailers?*, REALCLEARPOLICY.COM (Sept. 1, 2020), *available in*

interchange fee revenue, in turn, enables issuers to provide below-cost or even free credit card accounts to consumers, a variety of services such as anti-fraud protection and car rental insurance, as well as rewards such as cash-back or airline miles. Through the interchange fee, much of the cost of operating the payment card system traditionally has been borne by merchants, as in other two-sided platforms.

Getting the pricing right on consumer financial instruments is a crucial element of financial inclusion. For example, eliminating interest rate ceilings on credit cards also led to the elimination of annual fees, which had raised the costs for consumers of owning credit cards. In the case of bank accounts, the crucial development was the introduction of debit cards beginning around 2000, and their eventual supplanting of checks as a major transactional payment device by consumers. In 2000, debit cards transactions comprised about one-fifth of the transaction volume of checks and about half the volume of credit cards.[294] By 2006, however, debit cards passed credit cards to become the second most-popular noncash transaction device in terms of transaction volume and the next year debit cards passed checks as the most frequently-used noncash payment device.

This growth in debit card usage enabled a growth in access to bank accounts for many consumers. Traditionally, consumers bore most of the cost of maintaining a checking account by paying a monthly fee to defray the bank's costs of operating the account as well as bearing the cost of ordering checks. Although merchants benefited from the convenience and security provided by consumer use of checks instead of cash,

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https://www.realclearpolicy.com/articles/2020/09/01/would_a_shift_from_cards_to_cash_really_help_retailers_575902.html. The interchange fee is estimated at about 70%-90% of the total merchant discount fee. Hayashi, *supra* note 292.

[294] *See* BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE 2019 FEDERAL RESERVE PAYMENTS STUDY (Jan. 6, 2020), *available in* https://www.federalreserve.gov/paymentsystems/2019-December-The-Federal-Reserve-Payments-Study.htm.

especially for mail or larger transactions, consumers paid for all of those costs. Merchants received payment at "par" (i.e., 100 cents on the dollar) and consumers paid the bulk of the costs for this payment device.

The introduction of debit cards fundamentally transformed this economic relationship. Like credit card issuers, debit card issuers charge an interchange fee when consumers use their cards. As a result, banks were able to defray much of the cost of operating the debit card network through interchange fee revenues. With a few debit card transactions per month, many consumers could cover the bank's costs of providing bank account services. Banks used to pass on these benefits to consumers in the form of free checking programs. The result was potentially profound for consumers, especially for lower-income consumers and those previously not participating in the mainstream financial system.

Before 2001, it is estimated that fewer than ten percent of bank accounts offered free checking.[295] According to a survey report in 2001, the number of free checking accounts had risen to "an all time high of 7.5 percent, up from 7.1 percent" the year before.[296] By 2009, 76 percent of bank accounts were free checking accounts, according to one widely-cited estimate.[297] By dramatically expanding access to free checking and eliminating monthly maintenance fees, the introduction and rapid adoption of debit cards

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[295] *See* Todd J. Zywicki, Geoffrey A. Manne, and Julian Morris, *Price Controls on Payment Card Interchange Fees: The U.S. Experience* 5, ICLE FINANCIAL REGULATORY RESEARCH PROGRAM WHITE PAPER 2014-2 (2014), *available in* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2446080..
[296] *See* Laura Bruce, *Free Checking Accounts*, BANKRATE.COM (Oct. 15, 2001), *available in* https://www.bankrate.com/finance/checking/free-checking-accounts.aspx. The number of institutions offering free checking plans doubled between 2001-2006. *See* UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, BANK FEES: FEDERAL BANKING REGULATORS COULD BETTER ENSURE THAT CONSUMERS HAVE REQUIRED DISCLOSURE DOCUMENTS PRIOR TO OPENING CHECKING OR SAVINGS ACCOUNTS 15 (Jan. 2008),.
[297] Zywicki, et al., *Price Controls*, *supra* note 295, at 5.

dramatically expanded financial inclusion for many consumers who traditionally could not afford a bank account.

Section 1075 of Dodd-Frank, however, intervened to provide that interchange transaction fees for debit transactions shall be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction." (The interchange fee could also include reimbursement for costs related to fraud prevention.) By its terms, Section 1075 applies only to financial institutions with assets of $10 billion or more, which account for approximately 2/3 of all debit card transactions annually.[298]

Under this restrictive definition of permissible costs, debit card issuers were permitted to recover only the costs associated with "a particular electronic debit transaction," including the "authorization, clearance, or settlement, but not other costs associated with providing debit cards to consumers, such the costs associated with issuing cards, operating bank branches, advertising and account acquisition, ATMs, other teller services, or general customer support operations. The legislation instructed the Federal Reserve Board to prescribe regulations to implement the provision.

As instructed by Congress, in October 2011 the Federal Reserve's regulations governing interchange fees became effective. The consequences for covered banks was dramatic—interchange fees were slashed from approximately $0.51 per transaction (an average of signature and PIN debit combined) to a maximum $0.24 per transaction where it has remained more or less since that time.[299] The direct effect on covered banks was

[298] BOARD OF GOVERNORS FO THE FEDERAL RESERVE SYSTEM, REGULATION II (DEBIT CARD INTERCHANGE FEES AND ROUTING) (July 18, 2019), *available in* https://www.federalreserve.gov/paymentsystems/regii-average-interchange-fee.htm

[299] *See* Todd J. Zywicki, Geoffrey A. Manne, and Julian Morris, *Unreasonable and Disproportionate: How the Durbin Amendment harms Poorer Americans and Small Businesses*, INTERNATIONAL CENTER FOR LAW

initially estimated as a reduction in annual revenue of approximately $4.1-$6.5 billion[300] but has increased as time has passed and the volume of debit card transactions in the economy has continued to grow. According to one recent estimate, the annual lost interchange revenue to banks as a result of Section 1075 has grown from an estimated $8.9 billion in 2012 to $14 billion in 2019 and the total estimated lost interchange revenue as $90.9 billion since its implementation.[301]

As would be predicted by the basic theory of two-sided markets, financial institutions have responded to this revenue loss from merchants by passing on more of the costs of operating the platform to consumers. Of particular concern to the Taskforce, the manner in which those losses have been recovered from consumers has fallen particularly heavily on lower-income consumers and has erected a significant barrier to greater financial inclusion. In this sense, the harmful consequences of Section 1075's price controls are consistent with earlier experiences with similar price control programs such as usury ceilings, which typically disadvantage lower-income consumers relative to wealthier ones.[302]

Banks and credit unions covered by Section 1075 have responded to the law's effects in a number of ways. As noted, between 2001 and 2009 the percentage of bank

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AND ECONOMICS (APR. 25, 2017); *see also* BOARD OF GOVERNORS FO THE FEDERAL RESERVE SYSTEM, REGULATION II (DEBIT CARD INTERCHANGE FEES AND ROUTING) (July 18, 2019), *available in* https://www.federalreserve.gov/paymentsystems/regii-average-interchange-fee.htm.

[300] *See* Benjamin S. Kay, Mark D. Manuszak, and Cindy M. Vojtech, *Competition and Complementarities in Retail Banking: Evidence form Debit Card Interchange Regulation*, 34 J. FIN. INTERMEDIATION 91, 92 (2018); *see also* Vladimir Mukharlyamov and Natasha Sarin, *Price Regulation in Two-Sided Markets: Empirical Evidence from Debit Cards* (Dec. 2019) (estimating $5.5 billion annual revenue loss to banks from interchange fee reductions); Bradley G. Hubbard, *The Durbin Amendment, Two-Sided Markets, and Wealth Transfers: An Examination of Unintended Consequences Three Years Later* 20 (Working Paper, May 20, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2285105 (estimating annual revenue loss of $6.6 billion to $8 billion from Durbin Amendment).

[301] *See* ELECTRONIC PAYMENTS COALITION, EPC ANALYSIS OF THE COST OF THE DURBIN AMENDMENT (July 2020).

[302] Zywicki, *Economics of Credit Cards*, *supra* note 27, at 158-59.

accounts that were free accounts had increased by an order of magnitude, from 7.5 percent to 76 percent.[303] By 2013, that figure had fallen in half, to 38 percent.[304] At the same time, monthly maintenance fees for non-free checking accounts rose substantially, doubling in amount according to some estimates.[305] Moreover, maintenance fees did not creep up gradually over time—instead, the doubling occurred discretely in the second half of 2010, immediately after Dodd-Frank, including Section 1075, was passed, and then rose again slightly in 2011 when the regulations implementing Section 1075 were finalized.[306] The percentage of bank accounts subject to free checking has remained near this level since.[307]

A study by Mukharlyamov and Sarin using a different database identified an even larger reduction in access to free checking accounts, finding that the share of free basic checking accounts fell from 61percent to 28 percent as a result of Section 1075.[308] Similarly, they estimated that if Section 1075 had not taken effect 65 percent of bank accounts would have been free checking accounts, but that the actual number was 35 percentage points lower (30 percent).[309]

Economic studies have confirmed that much, if not most, of this revenue loss was recovered by affected banks through increased bank fees. Kay, et al., estimated that increases in deposit fees offset more than 90 percent of the lost interchange fee

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[303] *See* Zywicki, et al., *Price Controls*, *supra* note 295, at 6.
[304] Zywicki, et al., *Price Controls*, *supra* note 295, at 6.
[305] Zywicki, et al., *Price Controls*, *supra* note 295, at 7.
[306] Zywicki, et al., *Unreasonable and Disproportionate*, *supra* note 299, at 12.
[307] Zywicki, et al., *Unreasonable and Disproportionate*, *supra* note 299, at 11.
[308] Mukharlyamov and Sarin, *supra* note 300, at 4.
[309] Mark D. Manuszak and Krzysztof Wozniak, *The Impact of Price Controls in Two-Sided Markets: Evidence from US Debit Card Interchange Fee Regulation*, FEDERAL RESERVE BOARD, FINANCE AND ECONOMICS DISCUSSION SERIES 2017-074 (2017).

income.[310] Mukharlyamov and Sarin estimated that issuers lost approximately $5.5 billion in reduced interchange fee income annually, of which they recouped about $2.3 billion in higher bank fees, or approximately 42 percent of lost revenue.[311]

But the loss of access to free checking and exposure to higher bank fees was not randomly distributed among bank customers. The primary way in which banks rationed access to free checking following Section 1075's passage was by increasing the average minimum balance needed for a customer to be eligible for free checking.[312] In 1999, consumers were required to hold an average balance of $562 in the typical bank account in order to be eligible for free checking. By 2008, however, that figure had fallen to $109. By 2012, that figure had soared to $723 and has remained around that level since.[313] Needless to say, higher-income customers are much more likely to be able to meet or even disregard these higher minimum balance requirements than lower-income consumers. Manuszak and Wozniak estimated that as a result of Section 1075, the average minimum balance necessary to quality for noninterest free checking accounts increased by over $400 and by nearly $1,700 for interest-bearing checking accounts.[314]

Two recent surveys of bank account terms for the largest banks reported on their findings. The first study found that the that average monthly fee on the accounts reviewed had an average monthly fee of $9.60 per month ($115.20 per year) and the minimum

[310] Kay, et al. *supra* note 300, at 99 (noting that banks covered by § 1075 increased bank fees by about $4 billion total, offsetting a revenue reduction of approximately $4.1 billion in reduced interchange fees).
[311] Mukharlyamov and Sarin, *supra* note 300, at 2-4. They concluded that average checking account fees increased from $3.07 to $5.92 per month. *Id.* at 4.
[312] Zywicki, et al., *Unreasonable and Disproportionate*, *supra* note 299, at 11.
[313] Mukharlyamov and Sarin estimated a 21 percent increasd in the monthly minimum needed to be eligible for free checking and to avoid having to pay monthly fees.
[314] Manuszak Wozniak, *supra* note 300, at 5.

balance necessary to waive the fee $1,010,[315] The second survey reported an average monthly maintenance fee of $14.39 per month ($172.68 per year)[316].

Mukharlyamov and Sarin concluded, "These higher fees are disproportionately borne by low-income consumers whose account balances did not meet the monthly minimum required to waive these fees."[317] Overall, they found "[O]ver 70 percent of consumers in the lowest income quintile (annual household income of $22,500 or less) bear higher account fees, since they fall below the average post-Durbin account minimum required to avoid a monthly maintenance fee ($1,400). In contrast, only 5 percent of consumers in the highest income quintile (household income of $157,000 or more) keep balances falling below this threshold."[318]

These higher bank fees for lower-income consumers appear to have pushed many of them out of bank accounts entirely and into the ranks of the unbanked. According to the FDIC, between 2009-2011 the number of unbanked consumers rose by one million and then number of underbanked consumers rose by 3 million, forcing them to rely on alternatives that ultimately are more expensive, including money orders, prepaid cards, and check cashers.[319] As discussed above, the most frequently cited reasons that unbanked consumers have offered for not having a bank account is that minimum balance

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[315] *See* Theresa Kim, *Checking Account Fee Comparison at Top U.S. Banks*, MYBANKTRACKER.COM (Jul. 23, 2020), *available in* https://www.mybanktracker.com/news/checking-account-fee-comparison-top-10-us-banks. This survey includes one Internet bank that reports a monthly fee of zero, with no minimum balance required. If that bank is excluded, the average monthly fee would be $10.61.
[316] *See* Richard Barrington, *How Much are Bank Fees—The Latest MoneyRates Update* (Aug. 20, 2020), *available in* https://www.money-rates.com/research-center/bank-fees/.
[317] Mukharlyamov and Sarin, *supra* note 300, at 4. Banks may also wave monthly fees or deposit minimums where the consumer uses another bank product, such as auto loans or home equity loans. In general, it would be expected that higher-income customers would be more likely to seek further financial services of that type from the bank than lower-income individuals..
[318] *Id.* at 30.
[319] *See* Zywicki, et al., *Price Controls*, *supra* note 295.

requirements and account fees are too high, and the figure has risen steadily in the period since Dodd-Frank was enacted.[320] Moreover, unbanked consumers who previously had kept a bank account but no longer did were much more likely to cite high and unpredictable fees as a reason for not having a bank account. Mukharlyamov and Sarin found an 81 percent increase in the percentage of unbanked consumers stating that high account fees as their main reason for not having a bank account after Section 1075 was enacted.[321] Further, they found that residents in states that were most impacted by Section 1075 (those with the highest share of deposits at banks above the $10 billion threshold) were most likely to attribute their unbanked status post-Section 1075 to high fees.[322] The growth in the recently unbanked was also highest in states with more affected banks, where the increase in account fees is most pronounced.

Finally, banks covered by Section 1075 price controls also recouped interchange fee losses by eliminating or cutting card rewards programs on debit cards.[323] According to one estimate, rewards averaged approximately 5 cents per transaction prior to the passage of Dodd-Frank, an amount which was cut to average of about 2 cents per transaction after Dodd-Frank's enactment.[324] Credit card interchange fees and rewards, by contrast, remained unaffected. As a result, higher-income consumers avoided Section 1075's sting by increasing their use of credit cards for transactional purposes in place of

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[320] *See* discussion at *supra* note 129 and accompanying text.
[321] Mukharlyamov and Sarin, *supra* note 300, at 30.
[322] *Id.*
[323] *See* Darryl E. Getter, *Regulation of Debit Interchange Fees* at 8, CONGRESSIONAL RESEARCH SERVICE (May 16, 2017).); *see also* ELECTRONIC PAYMENTS COALITION, OUT OF BALANCE: HOW THE DURBIN AMENDMENT HAS FAILED TO MEET ITS PROMISES 7 (Dec. 2018). Eliminating rewards, such as cash-back on purchases, is functionally equivalent to a price increase.
[324] Kay, et al., *supra* note 300, at 99.

debit cards.[325] Lower-income consumers, by contrast, are less likely to have credit cards than high-income consumers, and as a result replaced their reduced debit usage with increased use of cash and checks.[326] According to a discussion paper by the Federal Reserve Bank of Philadelphia Consumer Finance Institute, this shift from debit card usage to credit card usage among consumers was driven by two factors: "regulatory changes in the debit space that limited interchange, making debit rewards less financially viable for depository institutions and a change in preferences by both card issuers and consumers for more and richer rewards as incentives for using a particular form of payment."[327] Ironically, therefore, the net affect of Section 1075's impact has been to exacerbate the alleged regressive effects of payment card interchange fees and rewards.[328]

Nevertheless, some commentators have argued that lower-income consumers benefit from interchange fee price controls because of the potential that the costs of interchange fees are passed through by merchants and are thus captured in retail prices that are paid by both cash and credit shoppers. One study often cited, for example, estimates that low-income households pay on average $21 per year in higher prices as a result of credit card interchange fees and card rewards and argues that price controls on

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325 *See* Zywicki, *et al.*, *Price Controls*, *supra* note 295, at 18-22; *see also* Vladimir Mukharlyamov and Natasha Sarin, *The Impact of the Durbin Amendment on Banks, Merchants, and Consumers*, INSTITUTE FOR LAW AND ECONOMICS RESEARCH PAPER NO. 19-06, at 34-35 (Jan. 2019); Tom Ankana, *Consumer Payment Prefernces and the Impact of Technology and Regulation: Insights from the Via Payment Panel Study*, Federal Reserve Bank of Philadelphia Consumer Finance Institute Discussion Paper DP 19-01 (Feb. 2019).

326 *See* Sergei Koulayev, Marc Rysman, Scott Schuh, and Joanna Stavins, *Explaining Adoption and Use of Payment Instruments by US Consumers*, 47 RAND J. OF ECON. 293 (2016). Kloulayev, et al., also note the same trends associated with higher and lower education levels.

327 Ankana, *supra* note 325, at 11.

328 The regressive effects of interchange fee price controls and the impact on payment card rewards mirrors the experience with interchange fee price controls in Australia, where rewards for ordinary cardholders decreased and the generosity of rewards programs for higher-income consumers increased. *See* Iris Chan, Sophia Chong, and Stephen Mitchell, *The Personal Credit Card Market in Australia: Pricing Over the Past Decade*, RESERVE BANK OF AUSTRALIA BULLETIN 55 (March Quarter 2012).

interchange fees would likely increase consumer welfare.[329] The authors of the study actually analyze the credit card market, not the debit card market, but for the purposes of illustration it can be used to look at the effects on consumers of debit card interchange fee price controls as well.

It turns out that pass-through argument rests on some questionable theoretical assumptions and empirical generalizations that have been subsequently found to be invalid.[330] For example, the authors assumed a 100 percent pass-through rate—i.e., that the *entire* savings from interchange fee reduction would be passed through by retail merchants to consumers. This was a completely unrealistic assumption based on existing knowledge at the time, and subsequent research has confirmed that merchant pass-through of savings is much less than 100 percent.

The most precise estimate of pass-through of savings is provided by Mukharlyamov and Sarin, who estimated that merchants passed through "at most" 28 percent of their debit card savings to consumers, while banks passed had passed through 42 percent of their interchange fee revenue losses to consumers (with most of those losses being passed on to lower-income consumers who pay higher bank fees). They estimate that the net result of this was a $4 billion transfer to merchants, of which $3.2 billion came directly from banks and $0.8 billion from consumers, who paid $2.3 billion in higher checking fees but received only $1.5 billion in lower prices.

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[329] *See* Scott Schuh, Oz Shy, and Joanna Stavins, *Who Gains and Who Loses from Credit Card Payments? Theory and Calibrations*, FED. RES. BANK BOSTON RESEARCH DEPARTMENT PUBLIC POLICY DISCUSSION PAPER No. 10-03 (2010); *see also* Aaron Klein, *How Credit Card Companies Reward the Rich and Punish the Rest of Us*, LOS ANGELES TIMES (Dec. 20, 2019), *available in* https://www.latimes.com/opinion/story/2019-12-20/opinion-how-credit-card-companies-reward-the-rich-and-punish-the-rest-of-us.

[330] *See* Ian Lee, Geoffrey A. Manne, Julian Morris, and Todd J. Zywicki, *Credit Where It's Due: How Payment Cards Benefit Canadian Merchants and Consumers, and How Regulation Can Harm Them*, MACDONALD-LAURIER INSTITUTE 25-33 ((Oct. 2013).

Using surveys of merchants a few years after Section 1075 became effective, Wang, Schwartz, and Mitchell, found that although some merchants received reductions in the merchant discount rate they paid, others saw their debit card acceptance costs increase.[331] They found an asymmetric response—merchants who saw their prices increase usually passed those increased costs onto their customers while very few of those who saw their debit costs decrease passed those costs onto customers. This suggests that there was very little pass-through of savings—certainly far less than 100 percent—and that if there was any substantial pass-through at all it was greatly delayed.[332]

Most obvious, and most important, the authors ignore the fact that reducing interchange fee revenues has forced banks to recoup their revenue losses from their customers in the form of reduced access to free checking and higher bank fees, costs which fall dramatically more heavily on lower-income families that are unable to meet the dramatically higher minimum balances necessary to retain access to free checking. Although the researchers estimate that lower-income consumers *could* save as much as $21 per year in lower retail costs from interchange fee price controls, this small cost is dramatically outweighed by higher bank fees that are estimated in the range of $115 to

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[331] Zhu Wang, Scarlett Schwartz, and Neil Mitchell, *The Impact of the Durbin Amendment on Merchants: A Survey Study*, 100(3) ECON. Q. 183 (2014) (3rd Quarter).

[332] An event study analysis by Evans, Chang, and Joyce concluded that when comparing the costs to banks from the loss of interchange fee revenues to the benefits to retailers, consumers lost substantially more on the bank side in higher costs than they gained on the retail side in price savings. They estimated that overall, the present discounted value of the losses for consumers from Section 1075 amounted to $22 billion to $25 billion. This finding of large abnormal returns for retailers suggests that much of the financial windfall from the enactment of Section 1075 would be retained by merchants instead of being passed through to consumers. *See* David S. Evans, Howard Change, and Steven Joyce, *The Impact of the U.S. Debit Card Interchange Fee Regulation on Consumer Welfare: An Event Study Analysis*, COASE0SANDOR INSTITUTE FOR LAW AND ECONOMICS (Oct. 2013).

$172 per year[333] That increase in fees resulted in the loss of bank access for many consumers.

Overall, the evidence indicates that operation of Section 1075 of Dodd-Frank has had a significant adverse impact on financial inclusion, especially for lower-income consumers. Access to free checking has dropped dramatically and bank fees have risen substantially. In turn, these higher fees have driven many lower-income consumers out of the mainstream financial system and pushed them toward greater reliance on alternative financial services providers such as check cashers and prepaid cards. In exchange there is little evidence of substantial pass-through of merchant savings to consumers, much less savings that would offset the dramatic increase in bank fees that have resulted, especially for lower-income consumers.

2. Credit CARD Act and Federal Reserve Regulations on Credit Card Terms

Recent laws and regulations have also impacted consumer access to credit cards. In 2009, Congress enacted the Credit Card Accountability, Responsibility, and Disclosure Act of 2009, generally known as the "CARD Act."[334] The law required new disclosures by credit card issuers. It also imposed new restrictions on contractual terms between consumers and issuers regarding the terms and amount of late and over-limit fees as well as the circumstances under which issuers can adjust interest rates in response to changes in the consumers' risk profile. Although passed in 2009, the CARD Act largely codified

[333] The author's analysis applies to credit cards not debit cards but, oddly, they assume that the annual fee on credit cards would remain the same after the imposition of interchange fee price controls.
[334] Pub. L. No. 111-24, 23 Stat. 1734 (2009).

similar Federal Reserve regulations proposed in May 2008 and adopted in December 2008 .[335]

Subsequent research has found that the CARD Act had the intended effect of reducing some costs for some consumers with respect to the terms that were limited by the law.[336] Nevertheless, the CARD Act also had substantial adverse unintended consequences for many other consumers in terms of card access, credit availability, and other prices, especially for non-prime borrowers.

At the time the Federal Reserve rules were announced and later when the CARD Act was enacted, industry experts predicted that the rules would likely reduce costs for some consumers, especially those who make late payments, fail to make minimum payments, or exceed credit limits. They also warned that the costs of the rules likely would be passed on to other consumers in the form of higher prices and lower credit lines. In particular, concern was expressed that the costs would fall most heavily on higher-risk and lower-income consumers in the form of higher interest rates and less access to credit cards.

For example, in the announcement of the Fed's rule in December 2008, Federal Reserve Governor Randall S. Kroszner observed, "Although consumers might see some costs decline as new business models emerge, consumer[s] might see other costs

[335] 74 FED. REG. 5498, "Unfair or Deceptive Acts or Practices" (Jan. 29, 2009). Although the rule was finalized on December 18, 2008 its effective date was set as July 1, 2010. In the meantime, Congress passed the CARD Act, so the Federal Reserve rule never took effect before being supplanted by legislation. Even prior to the Federal Reserve regulations, however, an early draft of the legislation was introduced in Congress in February 2008 as the "Credit Card holders' Bill of Rights Act of 2008" (H.R. 5244) contained substantively similar terms.

[336] For a summary of these effects *see* BUREAU OF CONSUMER FINANCIAL PROTECTION, THE CONSUMER CREDIT CARD MARKET (Aug. 2019).

increase."[337] Governor Kroszner also observed that issuers "might need to strengthen upfront underwriting efforts in the process," i.e., by restricting credit card access for higher-risk borrowers.

In his 2010 shareholder letter, JPMorgan Chase CEO Jamie Dimon predicted that the consequences of the CARD Act would be to reduce access and increase prices for its customers, especially for higher-risk and less-affluent customers.[338] He wrote, "However, because the new law makes it harder to raise rates on customers who have become far riskier… we and other competitors have had to make some fairly drastic changes in the business…." He noted that in response to the CARD Act, Chase had "substantially reduced very low introductory or promotion balance transfers," canceled the credit cards of those with dormant accounts, and "reduced limits on credit lines" by $1.4 trillion, from a peak of $4.7 trillion to $3.3 trillion. Finally, he observed, "In the future, we no longer will be offering credit cards to approximately 15% of the customers to whom we currently offer them. This is mostly because we deem them too risky in light of new regulations restricting our ability to make adjustments over time as the client's risk profile changes." Moreover, at the same time Chase was restricting access and credit lines to riskier borrowers because of its inability to price risk effectively, Dimon announced the bank's introduction of the Chase Sapphire card, which "was developed from the ground up to address the needs of affluent consumers, with premium rewards and exceptional service."

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[337] Statement of Governor Randall S. Kroszner (Dec. 18, 2008), *available in* https://www.federalreserve.gov/newsevents/pressreleases/kroszner20081218a.htm.
[338] *See* Jamie Dimon, Chairman and Chief Executive Officer, 2010 JPMorgan Chase Shareholder Letter 11 (Mar. 26, 2010), *available in* https://getoutofdebt.org/wp-content/uploads/chaseshareholders.pdf.

Empirical studies of overall effects of the Federal Reserve rules and the CARD Act have been largely as predicted. Some late-payers, non-payers, and those who exceed their credit limits have reaped cost savings from the CARD Act's restrictions on fees and interest rate adjustments. But compelling empirical evidence indicates that the costs of the CARD Act have been borne predominantly by other lower-income and higher-risk consumers who have found it more difficult to obtain a credit card, received lower credit lines, and higher paid interest rates and costs. Of particular note, economic studies indicate those who have lost access to credit cards or had their credit lines reduced as a result of federal law and regulations have substituted financial providers that charge higher prices and interest rates for credit card issuers. Higher-income consumers and lower-risk borrowers, by contrast, have seen few adverse consequences from the CARD Act.

A recent study by researchers at the Philadelphia Federal Reserve Bank and New York University analyzed the effects of the Federal Reserve's 2008 regulations and the CARD Act separately.[339] They found that the 2008 regulations and the CARD Act had similar and separate effects on consumers.[340] Both the Federal Reserve rules and the CARD Act had adverse effects on credit availability for non-prime borrowers while there was no corresponding reduction in availability to prime consumers. In fact, market effects at each stage of the progression of the original proposal of the regulations that eventually served as the basis for the CARD Act through the legislation's final passage and

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[339] Yiwei Dou, Julapa Jagtiani, Joshua Ronen, & Raman Quinn Maingi, *The Credit Card Act and Consumer Debt Structure*, FED. RES. BANK OF PHILA. RESEARCH DEPT. WORKING PAPER, WP 20-32 (Aug. 2020).

[340] Although the Federal Reserve regulations did not become effective until 2010, the authors sought to determine whether credit card issuers adjusted their underwriting criteria following the finalization of the Regulations in anticipation of their effect.

enactment of the final regulations implementing the Act were correlated with significant reductions in credit availability to non-prime consumers.

The finding that the CARD Act resulted in reduced credit access for subprime borrowers is consistent with other studies that found that the CARD Act resulted in higher prices, more restrictive credit availability, or both, especially when combined with impact of the Federal Reserve's earlier regulations. For example, Han, Keys, and Li analyzed credit card mail solicitations before and after the CARD Act's enactment and found that nonprime households were 6.6 percentage points less likely to receive an offer after implementation of the act, and that the offers they received had lower credit limits and higher interest rates than before.[341]

In some instances, researchers concluded that the Federal Reserve's regulations caused the primary impact, rather than the CARD Act itself. For example, Jambulapati and Stavins found that issuers closed credit card accounts around the period of the enactment of the Federal Reserve's rules but that in response to the CARD Act, issuers reduced available credit limits.[342] Santucci compared the terms of credit card accounts opened in 2005, the period predating both the Federal Reserve regulations and the CARD Act, with 2011, after the CARD Act had become effective.[343] He found that during that period the median initial credit limit fell by 60 percent (from $5000 to $2000) and that credit limit increases were lower as well. Moreover, "these effects were especially

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[341] *See* Song Han, Benjamin J. Keys, & Geng Li, *Unsecured Credit Supply, Credit Cycles, and Regulation*, 31 REVIEW OF FIN. STUDIES 1185 (2018).

[342] *See* Vikram Jambulapati & Joanna Stavins, *Credit Card Act of 2009: What Did Banks Do?*, 46 J. BANKING & FINANCE 21 (2014). By contrast, they found some evidence that higher-income and more educated consumers may have experienced an increase in credit lines during this same period.

[343] Larry Santucci, *A Tale of Two Vintages: Credit Limit Management Before and After the CARD Act and Great Recession*, FED. RESERVE BANK PHILA. DISCUSSION PAPER 15-01 (Feb. 2015).

pronounced among the riskiest 25 percent of accounts opened in 2011."[344] With respect to this group, he found that the median initial credit limit fell 66.7 percent to $500 and the median limit increase amount fell by at least 25 percent.[345]

Lux and Greene found a variety of developments in the credit card market that are likely attributable to the impact of the CARD Act.[346] They found, for example, that consumers with lower-credit scores comprised a smaller percentage of new credit card account originations in 2015 sand theat they were a smaller percentage of the revolving credit card market in 2015 than in 2007, A 2014 research report by Goldman Sachs also concluded that "lower-income borrowers [were] most affected" by the CARD Act and that although interest rates rose for all cardholders, interest rates for higher risk consumers rose substantially more than for prime consumers.[347] In addition, credit extensions to subprime borrowers plummeted in the period after the CARD Act while credit offers to "super-prime" borrowers increased.

Elliehausen and Hannon also examined the combined effects on consumers from the Federal Reserve regulations and the CARD Act together with the general effects caused by the financial crisis and subsequent recession during that period.[348] They found a general decline in credit card accounts at the beginning of this period, which they attributed largely to the effects of the financial crisis and recession, which led to deleveraging by consumers. But they also found a decrease in the *relative* number of bank accounts held by non-prime borrowers relative to prime borrowers during the period

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[344] *Id.* at 4.
[345] *Id.* at 4.
[346] Marshall Lux and Robert Greene, *Out of Reach: Regressive Trends in Credit Card Access*, Harvard Kennedy School Mossavar-Rahmani Center for Business and Government, M-RCBG Associate Working Paper Series No. 54 (Apr. 2016).
[347] GOLDMAN SACHS, WHO PAYS FOR BANK REGULATION? 7 (June 2014).
[348] *See* Elliehausen and Hannon, *supra* note 56.

of the implementation of the CARD Act: Where prime consumers suffered little adverse affect from the CARD Act, subprime consumers experienced a reduction in access to credit-card credit. Elliehausen and Hannon concluded, "Specifically, we found that the number of credit card accounts declined significantly during the CARD Act implementation period for both nonprime and prime consumers, but that the decline for nonprime consumers was more than that for prime consumers. We then showed that credit card account declined further for nonprime but not prime consumers after the CARD Act became effective. Part of the declines observed can be attributed to deleveraging related to the recession, but the larger further declines for nonprime customers likely were caused by the CARD Act's restrictions on risk management practices, which adversely affected higher risk consumers."[349]

Moreover, Elliehausen and Hannon found that many of those non-prime consumers that suffered loss of access to credit cards shifted their borrowing to traditional installment lenders, which typically offered higher costs and less flexibility than credit cards. If those consumers had preferred to use installment loans instead of credit cards, then presumably they would have done so prior to being forced by the CARD Act. Of course, for many non-prime consumers this option was only available in states where prevailing regulations (including usury ceilings) afforded consumers the option of installment loans. In states with restrictive laws, consumers were unable to avail themselves of those products. It is unclear where the latter individuals turned to meet their credit needs (such as payday loans, bank overdraft protection, or some other source). Elliehausen and Hannon observed, "These results suggest that the reduction in bank card

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[349] Elliehausen and Hannon, *supra* note 56.

availability may have prompted consumers to substitute consumer finance credit for bank card credit in states in which consumer finance credit is available."[350]

Other research is consistent with these findings. The CFPB's 2013 CARD Act Report, for example, identified a dramatic decrease in credit availability during the period of the CARD Act's passage and implementation.[351] Overall, the CFPB concluded that the percentage of households with credit cards declined by five percentage points during that period and that, overall, total credit lines available on all cards fell by $200 billion, with the greatest reductions in available credit lines for subprime borrowers. The CFPB also concluded, "Mail volume by credit card issuers soliciting new accounts fell much more dramatically for subprime borrowers than for all consumers," that "the approval rate for new cards for subprime borrowers fell much more than for other card segments, and "[o]riginations of new subprime accounts declined sharply."[352] On average, the CFPB estimated a 230 basis point increase in the purchase APR on credit cards and increases in cash advance fees.

A study by the Pew Trust soon after the enactment of the CARD Act found that while the newly-regulated fees (such as over-the-limit fees) declined as a result of the law, other fees increased.[353] They found that the average annual fee and average interest rates charged on credit cards increased, especially in the period after the issuance of the

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350 Elliehausen and Hannon, *supra* note 56.

351 CONSUMER FINANCIAL PROTECTION BUREAU, CARD ACT REPORT: A REVIEW OF THE IMPACT OF THE CARD ACT ON THE CONSUMER CREDIT MARKET (Oct 2013),

352 Thomas A. Durkin, Gregory Elliehausen, and Todd J. Zywicki, *An Assessment of Behavioral Law and Economics Contentions and What We Know Empirically about Credit Card Use by Consumers*, 22 S. CT. ECON. REV. 1, 48 (2014).

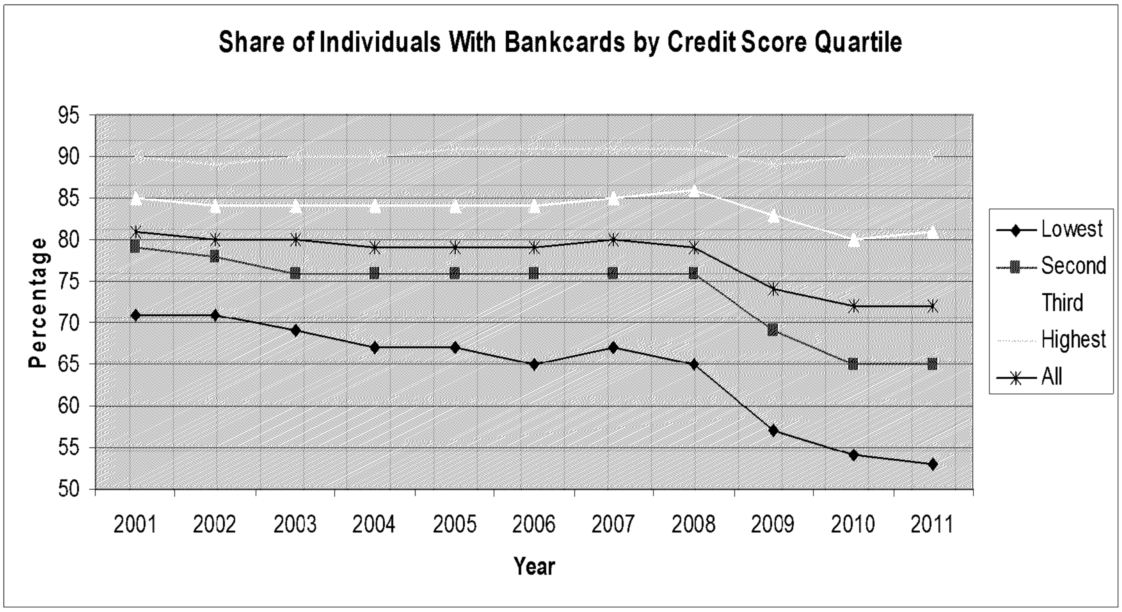
353 *See* Nick Bourke and Ardie Hollfield, *Two Steps Forward: After the Credit Card Act, Credit Cards Are Safer and More Transparent—But Challenges Remain*, Report of the Pew Health Group, Pew Trusts (July 2010).

Federal Reserve regulations. Pew also found that other fees not regulated by the CARD Act, such as cash-advance fees and other fees and penalty interest rates, also increased.

Overall, the period surrounding the enactment and implementation of the CARD Act was associated with a substantial decline in access to credit cards by higher-risk borrowers. By contrast, higher-income borrowers suffered little disruption in their access to credit cards. According to research by Federal Reserve Board economists Glenn Canner and Gregory Elliehausen, the percentage of households in the lowest quintile of credit scores with credit cards fell 11 percentage points, from 65 percent in 2008 to 54 percent in 2010.[354] By contrast, during that same period, card holding by households in the highest quintile of risk scores fell only 1 percentage point, from 91 percent to 90 percent of households.

Fogire 10-3: Credit Card Ownership By Credit Score Quintile

[354] Glenn B. Canner and Gregory Elliehausen, *Consumer Experiences with Credit Cards*, FED. RES. BULLETIN 10, Table 2 (2013).



Source: Glenn B. Canner and Gregory Elliehausen, *Consumer Experiences with Credit Cards*, 99 FED. RES. BULLETIN 10, Table 2 (2013).

Other studies have concluded that by constraining the ability of parties to adjust the price and other terms of the contract, the CARD Act likely reduced competition and resulted in higher prices for consumers. Analyzing the competitive effects of the CARD Act, Dou, Li, and Rosen found "a significant decline in the responsiveness of an issuer to competitors' changes in interest rates, but not in other credit terms that are unrelated to repricing."[355] Moreover, they found that this reduction in response of competitors was asymmetrical—reduced competitive effects were found only with respect to *decreases* in competitors' interest rates but not for *increases*. Further, they found that the adverse effect on competition was greatest with respect to subprime borrowers. They also found

[355] Yiwei Dou, Geng Li, and Joshua Rosen, *Does Price Regulation Affect Competition? Evidence from Credit Card Solicitations* at 27, FEDERAL RESERVE BOARD FINANCE AND ECONOMICS DISCUSSION SERIES 2019-018 (Feb. 2019), *available in* https://www.federalreserve.gov/econres/feds/files/2019018pap.pdf.

increases in price dispersion and markups, further evidence of reduced competitive effects.

In a theoretical analysis, Hong, Hunt, and Serfes, predicted that the CARD Act's limits on price adjustments would reduce competition for customers and result in higher up-front interest rates, on average, for all borrowers. The end result would be to "increase deadweight losses and reduce ex ante consumer surplus." Although Hong, et al., do not provide empirical analysis of their model, their prediction is consistent with the CFPB's findings that average interest rates on credit cards increased following the promulgation of the Federal Reserve's regulations and the enactment of the CARD Act.[356]

Three studies have purported to find minimal adverse effects on consumers from enactment of the CARD Act.[357] Each examined changes in credit card access and pricing "before" and "after" the CARD Act's passage. Unfortunately, all the studies take as their "before" period the time immediately preceding the CARD Act's effective date; as a result, they fail to account for any adjustments made by credit card issuers in response to the Federal Reserve's 2008 regulations.[358] This failure is crucial, however, because those studies that have considered the impact of the Federal Reserve's regulations on the credit card market consistently have found important and significant independent effects from

[356] *See* discussion at *supra* note 351 and accompanying text.
[357] *See* Scott Nelson, *Private Information and Price Regulation in the US Credit Card Market* (MIT Working Paper, 2018); Sumit Agarwal, et al., *Regulating Consumer Financial Products: Evidence from Credit Cards*, 130 Q. J. ECON. 111 (2015); Oren Bar-Gill and Ryan Bubb, *Credit Card Pricing: The CARD Act and Beyond*, 97 CORNELL L. REV. 967 (2012).
[358] DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at 46-52; Todd Zywicki, *No, the Credit Card Act is Not a Free Lunch*, WASHINGTON POST (Jan. 13, 2016). In fact, Agarwal, et al., does not even mention the 2008 Federal Reserve regulations. Bubb and Bar-Gill mention only the Federal Reserve's CARD Act regulations that accompanied the CARD Act but do not mention the 2008 Regulations (their timeline of significant events begins with the enactment of the CARD Act in May 2009). Nelson mentions the 2008 Federal Reserve regulations but makes no further effort to control for any effect they might have had on the credit card market.

those regulations. As a result, the "before" period identified by these researchers is not the "before" period, as it includes adjustments made by card issuers in response to the Federal Reserve's regulations.[359]

Overall, it appears that the CARD Act had an effect effect of reducing costs for those who overdraw their credit limits, late payers, and others directly affected by the CARD Act's terms. However, these benefits came at significant costs to many other consumers through higher interest rates, increases in other unregulated fees, reductions in credit lines, and reduced credit card availability. As predicted by Governor Kroszner at the time of the Federal Reserve regulations and later by Jamie Dimon when the CARD Act became effective, unfortunately the brunt of these market adjustments were felt most heavily by higher-risk borrowers relative to higher-risk borrowers, as well as reducing competition in the credit card market. As noted by Elliehausen and Hannon, many higher-risk borrowers who lost access to credit cards appeared to switch to increased use of personal installment loans where possible, which feature higher interest rates and other costs than the credit cards that they previously used.

The CFPB recently summarized its conclusions about the overall effects of the CARD Act on consumers since its enactment and implementation.[360] With respect to card

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[359] *See* Bar-Gill and Bubb, *supra* note 357 (identifying the "before" period as February 2010-August 2010); Nelson, *supra* note 357, at 8 (identifying "before" period as July 2008 to June 2009), Agarwal, et al., *supra* note 357 (identifying "before" period from March 2008 to April 2009). As noted by Dou, et al., summarizing the problem, "While our sample and design differ from [Agarwal, et al.] in many aspects, one key difference is that our anticipation period [2008Q1-2009Q1] largely overlaps their pre-period (March 2008-April 2009). Since the effect of the CARD Act first appears in our anticipation period and persists afterward… it is unsurprising to observe insignificant changes from the anticipation period to [the CARD Act] period. Our findings highlight the importance of identifying the timing of the treatment effect and choosing the pre-period accordingly."[359] As a result, by failing to control for the overall effects of relevant regulation, these studies are not meaningful efforts to assess the effects of the overall combined effects of the Federal Reserve regulations and CARD Act on consumer welfare.

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fees, the CFPB concluded that (1) over-the-limit fees and late fees have declined, (2) the size and prevalence of annual fees have increased, and (3) total fees have declined overall. The CFPB also concluded that the account-weighted average Annual Percentage Rate on card accounts had increased by 230 basis points and that the CARD Act had clear adverse effects on credit availability, especially for consumers with subprime scores and young adults, as well as stricter limits on credit lines.

To date, researchers have not attempted to measure the net welfare costs of these offsetting adjustments to the CARD Act, especially for higher-risk and lower-income consumers or the overall impact of those regulations on financial inclusion and competitive conditions in the credit card marketplace. Available research suggests that these costs could be significant, especially when considering the shift in use by consumers of higher-cost alternative sources of credit, such as installment loans. In states where installment loans are not available, it is not clear what products consumers substituted instead.

B. Postal Banking

One common proposal put forward from time to time to increase financial inclusion is to permit the United States Postal Service to offer consumer financial products in some fashion or another. The contours and details of what a postal banking system would include tend to be somewhat vague and ill-defined.[361] Some proposals are quite modest, suggesting a role for the Postal Service in providing money orders,

[360] *See* BUREAU OF CONSUMER FINANCIAL PROTECTION, CARD ACT RULES REVIEW PURSUANT TO THE REGULATORY FLEXIBILITY ACT; REQUEST FOR INFORMATION REGARDING CONSUMER CREDIT MARKET 15-16, 85 FR 53299, 12 CFR 1026 (Aug. 28, 2020)

[361] *See* UNITED STATES POSTAL SERVICE, OFFICE OF INSPECTOR GENERAL, THE ROAD AHEAD FOR POSTAL FINANCIAL SERVICES (May 21, 2015); *see also* Mehrsa Baradarn, *It's Time for Postal Banking*, 127 HARV. L. REV. F. 165 (Feb. 24, 2014); Mehrsa Baradaran, *How the Poor Got Cut out of Banking*, 62 EMORY L. J. 483 (2013).

remittances, and other alternative financial products. Many postal banking proposals focus on enabling the Service to provide transaction and savings accounts for consumers. Broader but even more undefined proposals would enable the Post Office to go beyond provision of these limited financial services and to make small-dollar loans as a competitor to existing payday and personal installment lenders. Because suggestions are largely undefined, detailed discussion of postal banking proposals is largely beyond the scope of the Taskforce report, but it also seems like postal banking is unlikely to promote increased financial inclusion compared to public policies directed toward promoting greater competition from existing innovators and competitors.

From 1911 to 1966 the Post Office provided limited financial services through the Postal Savings System.[362] The modern argument for postal banking primarily rests on the large number of existing physical Postal Service buildings in the United States today and the declining foot traffic and use of these facilities as consumers shift away from traditional postal delivery. This excess physical capacity and the ubiquity of branches, it is sometimes argued, could be put to work to provide banking services to residents of lower-income communities with limited bank branches.[363]

In practice, it is questionable whether Postal Banking would do much to address the financial inclusion issue. But this rationale of locational convenience appears to offer a solution to a non-problem aspect of the unbanked issue and fails to address actual problems for unbanked consumers. According to the most recent FDIC survey of

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[362] *See* Diego Zuluaga, *Postal Savings: A Third-Class Remedy?*, ALT-M.ORG (Sept. 22, 2020), *available in* https://www.alt-m.org/2020/09/22/postal-savings-a-third-class-remedy/.

[363] According to an estimate by a pro-postal banking organization, there are more than 30,000 Post Office retail locations around the country. *See* CAMPAIGN FOR POSTAL BANKING, http://www.campaignforpostalbanking.org/know-the-facts/.

unbanked consumers, only 14 percent of unbanked consumers list "Bank Locations are Inconvenient" as a reason for being unbanked and only 2 percent list it as the primary reason, the eighth of nine enumerated options provided in the survey.[364] In short, lack of physical access to a bank appears to present a relatively small barrier to inclusion for most unbanked consumers and, thereefore, investing substantial sums in building out banking services in Post Offices and the relevant infrastructure is likely to have a small return on social investment.[365]

Based on its history, it seems unlikely that the Postal Service can compete on the terms and qualities that financial services customers expect today—speed, efficiency, and adoption of innovative technologies that provide greater convenience, variety, and lower cost.[366] It also seems that the Postal Service will be able to offer a response to those unbanked consumers who lack bank accounts because "bank hours are inconvenient."[367] With respect to the cost of the financial services, even with its subsidized business

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[364] *See* FDIC SURVEY 2019, *supra* note, at 17 Fig. 3.5.

[365] Due to its status as a federal government agency, a Postal Service bank in whatever form it takes is also unlikely to provide a solution to consumers who are unbanked either because of privacy concerns or lack of sufficient documentation to open a bank account, such as citizenship requirements or anti-money laundering regulations. Proponents of Postal Banking also have pointed to the observation discussed above that another commonly-state reason by unbanked consumers for their lack of interest in a bank account is that they "Don't Trust Banks." As discussed earlier in this chapter, this seems to be an umbrella answer for more general concerns relating to feeling welcome and valued as customers instead of pure "trust." The history of the country's first "postal bank" that operated from 1910-1966 is consistent with that observation. As noted by Diego Zuluaga, the original postal banking system was established in 1910 following the banking Panic of 1907 as an indirect mechanism for the federal government to guarantee personal deposits. Part of its stated mission was to offer savings accounts with a "comparatively low rate of interest." Zuluaga, *Postal Savings*, *supra* note 362. The establishment of deposit insurance during the New Deal obviated that insurance rationale and led to an inevitable outflow of household savings from the Post Office to commercial bank accounts that offered the same guarantees but at a higher level of interest and service. *See* Diego Zuluaga, *Going Postal? Proposals for Post-Office Banking in 2020*, WWW.ALT-M.ORG, *available in* https://www.alt-m.org/2020/10/16/going-postal-proposals-for-post-office-banking-in-2020/.

[366] *See* Todd Zywicki, *Postal Banking Isn't the Fix for Financial Inclusion*, AMERICAN BANKER (June 13, 2019).

[367] The number of survey respondents who identify inconvenient bank hours as a reason for being unbanked is about equal to the number who blame inconvenient locations with slightly more identifying inconvenient hours as the "main" reason for being unbanked. *See* FDIC SURVEY 2019, *supra* note, at 17, Fig. 3.5.

structure the Post Office currently charges higher prices for the financial products and services it makes available, including check cashing and money orders, than competitors like WalMart.[368] Increased competition and innovation in the market for money transfers and remittances has driven down the price of those products elsewhere.[369] Retailers such as WalMart also currently offer longer hours that are more convenient for financial activities than the Postal Service.[370] Moreover, a primary reason why many low-income consumers use products such as check cashers and money orders is to address the chronic problem caused by the slowness of the payment-clearance system. Unless there is some reason to believe the Postal Service would be able to clear checks more rapidly than commercial banks currently do, demand for check cashing, money orders, and small-dollar loans is likely to be only marginally impacted by the provision of Postal Banking services. Reforms such as adoption of a faster payments system seems like a more relevant avenue.

In the end, it appears that the essence of a Postal Banking system is primarily a subsidized public utility model of banking services coincidentally hitched to the Postal System because of the excess capacity provided by its legacy real estate holdings. If that is the case, it is not obvious why the best way to effectuate those subsidies is through in-kind subsidies offered by the Post Office instead of directing subsidies, tax benefits, or

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[368] *See* Zywicki, *Postal Banking*, *supra* note 366 (noting that WalMart typically charges 88 cents for a money order compared to $1.25 at the Post Office).
[369] *See* Mauro F. Romaldini, *How Is the International Money Transfer Market Evolving?*, WWW.TOPTAL.COM (undated), *available in* https://www.toptal.com/finance/market-research-analysts/international-money-transfer. In addition to general technological cost efficiencies that have reduced costs (and prices), one fintech innovation has been to use a "peer-to-peer" model of matching consumers' transactions off against each other, thereby eliminating the need to transfer currencies manually via transactions with third parties in the interbank market. Although that process is unlikely to eliminate interbank remittances entirely because it requires a symmetry of flows between countries, for many transactions it can eliminate or dramatically reduce costs.
[370] *See* Zywicki, *Postal Banking*, *supra* note 366.

some other government-provided incentives for the private sector to provide those services. A more promising strategy, for example, might be to provide financial subsidies for consumers to acquire prepaid cards or bank accounts from private banks, rather than forcing them to deal with a single monopoly governmental provider for financial services.

The future of financial inclusion is online. For all its virtues as a 20th Century public utility with economies of scale and large network of physical locations, it is difficult to see how the Postal Service is primed to provide innovative, convenient, timely, and low-cost products as financial services become increasingly electronic and mobile, and increasingly less dependent on physical access to bricks-and-mortar buildings and 9-to-5 hours of operation.[371]

C. Promoting Competition Through Industrial Banks and Fintech

The Taskforce believes that competition, entry, and innovation are better ways to promote greater financial inclusion. This could mean clearing away existing regulatory and other barriers to entry by non-traditional suppliers such as traditional and online retailers such as WalMart and others with broad experience at reaching a broad diversity of customers.[372] In this vein, the Taskforce has been pleased to see the FDIC's recent actions to lift its longstanding moratorium on approving the applications of new industrial bank charters[373] and to propose a new rule for chartering industrial banks and industrial

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[371] *See* Testimony of Merhrsa Baradaran before the United States House of Representatives Committee on Financial Services Task Force on Financial Technology (June 11, 2020) (arguing that the banking and payments systems should be understood as public utilities).
[372] *See* Zywicki, *Postal Banking*, *supra* note 366.
[373] *See* Anna Hrushka, *Rakuten to Continue ILC Charter Pursuit, Subsidiary CEO Says*, BANKINGDIVE.COM (Aug. 26, 2020), *available in* https://www.bankingdive.com/news/rakuten-to-continue-ilc-charter-pursuit-subsidiary-ceo-says/584189/.

loan companies.[374] As discussed in Chapter 9, the Taskforce also endorses the principle of some sort of federal financial charter for fintech firms and other firms with inherently interstate operations, such as money transmitters, that would enable them to operate under a reasonably uniform set of laws nationwide. It is the view of the Taskforce that eliminating archaic barriers to competition and innovation from new providers and regulatory restrictions that increase the costs of bank accounts and undermine natural market incentives to seek new customers will prove far more effective at promoting financial inclusion for those who need it than trying to retrofit a 20th Century model of financial services to a 21st century financial marketplace.

D. A Better, Faster, and More Innovative Banking and Payments System

A major barrier to greater access and higher quality in financial services is the antiquated payments system in the United States. As discussed earlier, adoption of a faster system of payments clearance would reduce the need for some consumers to rely on alternative financial service providers to gain access to their funds in a way that pays bills and avoids costly bank fees and bounced checks. There are several proposals currently under consideration to implement faster payments. The Taskforce does not endorse one proposal over the other. On the other hand, the slow pace of change in the United States is frustrating and costly for consumers, especially low-income consumers operating at the financial margin. Such a system is possible—the United Kingdom switched to instant or "real-time" payments over a decade ago.[375]

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[374] *See* Federal Deposit Insurance Corporation, *Parent Companies of Industrial Banks and Industrial Loan Companies*, 85 FED. REG., No. 62, at p. 17771 (Mar. 31, 2020).
[375] *See* Selgin and Klein, *supra* note 136.

Financial inclusion also would be furthered by reforming how financial institutions provide bank accounts to unbundled transaction services from other elements. Traditional banking relationships offer in a single relationship an array of standardized and convenient products and services suitable for the vast number of middle class Americans. Banks provide a combination of products to consumers—they simultaneously provide transaction account service and a lending and borrowing service. Transaction accounts provide the ability to write checks or process ACH, debit, or credit transactions, all of which rest on consumers' access to a bank accounts. But at the same time, banks offer a variety of lending and borrowing services—for example, banks pay interest on savings and money market accounts because of their ability to convert those deposits into loanable funds.

This second tranche of services, such as the sale of loans and other financial products, are responsible for both a disproportionate amount of the costs and risks of banking, as well as its profits. But this system of multiple products creates a complex system of potential cross-product and cross-consumer subsidies to try to maximize the bank's revenue streams and customer base.[376] For instance, consumers who use other bank products, such as mortgages or overdraft protection, provide subsidies to those consumers who do not. And consumers who use expensive services, such as bank tellers

[376] For example, with respect to savings and demand deposit accounts, consumers who maintain a higher balance consumers (who are also usually higher-income) provide subsidies to consumers with lower average balances. Consistent with the Pareto (or "80-20") principle, 85.7% of consumer checking accounts represent only 17.2% of the dollar balances and 14% of checking accounts provide 83% of the checking account balances. Yet deposit holders who provide much larger balances receive only slightly higher rates of interest than those who provide far less. *See* G. Michael Flores and Todd J. Zywicki, *Commentary: CFPB Report Data Point: Checking Account Overdraft* 8 (Sept. 2014), *available in* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2499716.

and physical branch locations, are subsidized by those consumers who rarely use those services.

The economic logic of combining financial services within one provider is compelling for both consumers and providers. For consumers, dealing with one primary financial institution provides efficiencies in transaction costs. With respect to providers, providing multiple products allows economies of scope in product offerings; for example, one bank branch with half a dozen employees can offer a wide array of products from car loans to checking accounts to money transfer services. In addition, by offering an array of services, banks can gain enough participation in consumers' finances that they can recommend products that will best meet their needs (cross selling)..

Economists have long understood that these transaction costs and internal information flows help to explain decisions by firms to offer products in a bundled or unbundled fashion.[377] Firms will tend to grow in size so long as the savings from greater economies of scope and internal management of production exceed the costs of managing a far-flung and diverse enterprise with hundreds or thousands of employees. For several decades, banks grew in size and complexity so as to capture economies of scope and to offer an increasingly complex array of products and services.[378]

Over the past two decades, however, technological innovations have disrupted these kinds of relationships dramatically, not just in domestic financial services but across the entire global economy. In some instances, these innovations have driven down

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[377] *See* Ronald Coase, *the Nature of The Firm*, 4 ECONOMICA 386 (1937); *see also* Charles Calomiris and Thanavut Pornrojnangkool, *Relationship Banking and the Pricing of Financial Services*, 35 J. OF FIN. SERVS. RESEARCH 189 (2009).
[378] *See* Charles W. Calomiris, *Gauging the Efficiency of Bank Consolidation During a Merger Wave*, 23 J. OF BANKING AND FIN. 615 (1999).

information costs sufficiently to generate massively-scaled companies with hugely complex consumer ecosystems. In other markets, however, these same dynamics have driven unbundling of the consumer experience by enabling providers to generate well-designed, boutique-style products at low cost and designed to meet specific needs of specific consumers in ways not being met adequately by supermarket-style product offerings. In these markets, the opportunity to offer these highly-tailored niche products to many consumers without the constraints of physical location have generated an unbundling of consumer banking as consumers increasingly interact with multiple different financial service providers to meet their needs instead of only one institution. This ability and willingness to engage in product unbundling appears to be particularly common among younger consumers who are comfortable with shopping on the Internet and using multiple different providers for different purposes.

Today, the evolution of consumer financial services is rendering increasingly obsolete the traditional association of financial inclusion with ownership of a bank account. Today, many consumers increasingly use a mixture of financial services like accounts that provide transaction capability with "alternative" (non-bank) providers. For example, by far the fastest-growing nontraditional financial product according to the FDIC is peer-to-peer, app-based payments such as Venmo, a category of "alternative" financial products which hardly even existed a few years ago.[379] Despite its novelty, peer-to-peer payments were used by almost 1/3 of the respondents in the 2019 FDIC survey of unbanked consumers, far outpacing the usage by any other nonbank financial transaction

[379] 2019 FDIC SURVEY, *supra* note 121, at 6 (noting that the 2019 survey was the first to ask about use of peer-to-peer payments).

service.[380] Indeed, use of these products, especially among certain subsets of consumers, has become so ubiquitous that many consumers might not even think of these products as "alternative" in nature. They are simply viewed as a complement to traditional financial services that meet a need for faster payments through a user-friendly interface.[381] In fact, those who use peer-to-peer payment systems are four times more likely to be banked than unbanked.[382] Not surprisingly, those who use peer-to-peer payments tend to be high income, college educated, and younger. So much of the commentary on the value of unbundling bank account services for financial inclusion has focused on "fintech *lenders*," i.e., those companies that are using alternative data and other underwriting and servicing technological innovations to provide small-dollar loans. These innovations are important for promoting financial inclusion and are discussed elsewhere in the Taskforce report.

Disconnecting transaction capabilities from bank accounts also provides promise for financial inclusion for consumers. Transactional services are increasingly electronic in nature, incurring minimal marginal costs and with little expensive human intervention and oversight. Many consumers only need access to bank accounts primarily for transactional purposes and do not need the panoply of bank services.The value of having widespread access to a transaction account was illustrated during the Covid-19 pandemic and the federal government's financial stimulus efforts.[383] Those consumers who had bank accounts were able to have the government deposit those funds directly into their

[380] *Id.* at 35, Fig. 6.1 (noting that P2P Payment Service was used by 31.1 percent of respondents and the category of "Money Order, Check Cashing, or Bill Payment Service" was second at 17.2 percent).
[381] And, in fact, the competitive pressures provided by the rapid growth Venmo and similar providers prompted banks to respond with their own real-time peer-to-peer payments system named Zelle.
[382] 2019 FDIC SURVEY APPENDIX TABLES, *supra* note 140, at 60, Table D.1.
[383] *See* Testimony of Merhrsa Baradaran before the United States House of Representatives Committee on Financial Services Task Force on Financial Technology (June 11, 2020).

accounts. Those who did not have account, by contrast, had to wait to receive their stimulus checks (sometimes weeks) or pay fees to alternative financial service providers to cash their checks.

The emergence of low-overhead branchless banks provides one potential mechanism for providing low-frills inexpensive bank accounts. Prepaid cards have evolved to meet some consumer demand for transaction services without the need for a formal bank account and provide a foundation for future unbundling of transaction accounts from traditional bank accounts.[384] Prepaid cards are almost four times more likely to be used by unbanked consumers than among the overall population.[385] Prepaid cards issued by large banks, however, are subjected to Dodd-Frank's price controls on debit card interchange fees under certain conditions, and this, in turn, has required major banks either to provide cards with limited functionality or to impose fees on consumers. Eliminating price controls on debit card interchange fees generally, or their application to prepaid cards specifically, would help to enable prepaid cards to evolve into functional, lower-cost transactional and simplified mobile banking platforms that would effectively meet the needs of many consumers who do not want or need the entire package of services offered by a traditional banking account. Digital wallets are also becoming increasingly available to provide transactional services.

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[384] General-purpose prepaid debit cards now account for 10.5 percent of all card payments in the United Staes. *See* BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE 2019 FEDERAL RESERVE PAYMENTS STUDY (2019); *see also* Todd J. Zywicki, *The Economics and Regulation of Network Branded Prepaid Cards*, 65 FLA. L. REV. 1477 (2013).
[385] 2019 FDIC SURVEY, *supra* note 121. In 2019 27.7 percent of unbanked households used prepaid cards, compared to 7.4 percent of banked households.

Lower-income and unbanked consumers are also more likely than the average American to use cash for transactions and to carry larger amounts of cash.[386] In addition to the obvious risks associated with higher cash usage (loss or theft), they pay higher costs on aggregate for cash access, including the time and convenience costs of having to travel to acquire cash from ATMs or check cashers. Wealthier Americans with bank accounts carry smaller amounts of cash on average, travel less to access cash, and pay few, if any, fees. During the Covid pandemic of 2020, many consumers also expressed a heightened fear of cash as a transmitter of disease and many consumers switched to electronic and touchless payments to reduce their contact with cash.[387]

Fintech providers have been active in developing products that can provide low-cost or free transaction accounts to consumers.[388] The ability of these upstart entrants to provide free or low-cost services seems to result from several sources. First, these payments companies typically operate by partnering with a smaller bank (one that is below the $10 billion asset threshold established by Dodd-Frank) to process their payments. As a result, these payment processors can cover most of their operating costs through interchange fee revenues. Second, because they operate only online without the cost and capital expense of bricks and mortar (such as branches and the ATM network) and can replace substantial amounts of employee costs with heavy reliance on technology, fintech payments processors have much lower operating costs than

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[386] *See* BHASKAR CHAKRAVORTI & BENJAMIN D. MAZZOTTA, THE COST OF CASH IN THE UNITED STATES, The Institute for Business in the Global Context, Tufts University Fletcher School (Sept. 2013).

[387] *See* Jeff John Roberts, *Most Americans Now Fear Touching Cash, Survey Says*, FORTUNE.COM (Aug. 11, 2020), *available in* https://fortune.com/2020/08/11/coronavirus-is-cash-safe-during-covid-germs-money/.

[388] *See* Hugh Son, *Chime is Now Worth $14.5 Billion, Surging Past Robinhood as the Most Valuable U.S. Consumer Fintech* (Sept. 18, 2020), *available in* https://www.cnbc.com/2020/09/18/chime-is-now-worth-14point5-billion-surging-past-robinhood-as-the-most-valuable-us-consumer-fintech-.html.

traditional banks. Third, payments data offers providers of these services visibility into consumers' shopping and financial habits in ways that they can use to develop new or tailored product offerings to consumers. Offering free or low-cost transactions services may also be an effort to establish a lifetime relationship with consumers. They may also be useful for immigrants who face short-run obstacles to accessing bank accounts and traditional financial services. .[389]

Regulators should consider allowing non-banks access to the payments processing system as a vehicle for enabling consumers to gain access to low-cost and convenient payments processing. Barring non-banks from access to the payments system creates a chokehold between some consumers and better, less-expensive, and innovative payments systems and it drives consumers toward traditional bank accounts that have not met their needs. The Taskforce is aware that there are challenges and offsetting concerns associated with this proposal, especially concerns about risk to consumers and the financial system as well as concerns about anti-money laundering.[390] On the other hand, it sees great potential to enabling consumers to access payments and other transactional financial services without the accompanying cost and complexity of a bank account. Expanding the pool of possible payments providers to include non-banks also would likely increase entry, competition, and innovation in this realm, leading to further improvements.

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[389] Fintech can also provide solutions for other issues that disproportionately affect higher-risk borrowers. For example, a company called Convoke has developed a cloud-based accounts receivable and collections platform that addresses many of the problems of information and document retrieval that is a common source of consumer complaints over debt collection. *See Convoke Adopted by 15 of the Top Debt Buyers in the USA* (Jan. 19, 2011), *available in* https://www.insidearm.com/news/00039607-convoke-adopted-by-15-of-the-top-debt-buy/.

[390] *See* BANK FOR INTERNATIONAL SETTLEMENTS, NON-BANKS IN RETAIL PAYMENTS (Sept. 2014); *see also* Barak J. Sanford and Daniel Bufithis-Hurie, *Should non-Bank Payment Firms Be Eligible to Open Federal Reserve Accounts*, BANKING PERSPECTIVES (Fourth Quarter 2018) (Nov. 25, 2018).

Non-bank provision of payments services by telephone companies and others is common in other countries with great benefits to consumers. The evolution of Kenya's M-Pesa telephone network into a payments system is one of the most well-known and established non-bank provider of payments. Throughout sub-Saharan Africa today there are more registered mobile money accounts than the total number of bank accounts in the region.[391] Other technology companies are developing technological solutions that have enabled consumers to move in and out of existing payment and banking relationships.on an as-needed basis.[392]

The consumer payments revolution in China, however, may be the most promising example of the potential benefits to consumers in the area of payments that competition and innovation have provided. As analyst Aaron Klein put it, "China has experienced a retail payment revolution. Leapfrogging the card-based system, two new payment systems have come to dominate person-to-person, retail, and many business transactions."[393] These "two new payments systems" are Alipay (which runs through Alibaba, China's largest online retailer) and WeChat Pay (which runs through China's dominant social network), each of which now reports more than one billion monthly users of their payments services and processing more than $41 trillion (277 trillion yuan) annually.[394] Available funds are stored in digital wallets and are transferred through unique QR codes scanned through smart phones, a system that largely disintermediates banks from payment transactions.

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[391] *See* Tilman Ehrbeck and Alex Lazarow, *Now that FinTech Has Unbundled our Financial Lives, Can it Re-bundle Them?*. MEDIUM.COM (Jun 29, 2017), *available in* https://medium.com/positive-returns/now-that-fintech-has-unbundled-our-financial-lives-can-it-re-bundle-them-fd34a0946840.
[392] *Id.*
[393] *See* AARON KLEIN, CHINA'S DIGITAL PAYMENTS REVOLUTION (Apr. 2020), *available in* https://www.brookings.edu/research/chinas-digital-payments-revolution/.
[394] *Id.*

In the United States, large retailers such as Amazon and WalMart or social networks, such as Facebook, have explored the creation of similar payment networks.[395] Large online social and gaming networks are potentially fertile sources to develop robust internal payment networks. In the United States, however, efforts to establish new payment networks have met with regulatory challenges, some of which raise legitimate concerns but many of which seemingly reflect political efforts by banks and other incumbent financial services providers to stifle entry from innovative new competitors, much as traditional banks fought WalMart's entry into banking a decade ago.[396]

Over the longer term, another potential additional source of innovative solutions to financial inclusion challenges is the use of blockchain and other cryptocurrencies, particularly stable-value coins.[397] These solutions potentially would enable consumers to entirely disintermediate traditional financial providers and to engage in direct peer-to-peer payments. As traditional employment relationships evolve under the pressures of the "gig economy" and other new work arrangements, these sorts of peer-to-peer payments systems could become increasingly common, enabling the establishment of novel forms of payments and transactions that have minimal and sporadic interactions with the payment systems.

Growth of peer-to-peer and nonbank provision of payments provide novel challenges to the regulatory framework but also novel and revolutionary opportunities for

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[395] *See id.* at 15-16; *see also* Lucas Jankowiak, *Payments Innovation Is "Unbundling" Banking*, WWW.PAYMENTSSOURCE.COM (Apr. 17, 2017), *available in* https://www.paymentssource.com/opinion/payments-innovation-is-unbundling-banking.
[396] *See* Craig Torres, *Bankers Advising Fed Board Describe Libra as a Monetary Threat*, WWW.BLOOMBERG.COM (Sept. 30, 2019), *available in* https://www.bloomberg.com/news/articles/2019-09-30/bankers-advising-fed-board-describe-libra-as-a-monetary-threat.
[397] *See* Amit Sharma, *Underbanked Households Would Benefit from a Regulated Blockchain*, AMERICAN BANKER (Aug. 26, 2020).

consumer benefits. Innovations such as promoting faster payments and eliminating regulatory barriers that reduce access to traditional bank accounts are important short and medium-term solutions for increasing access within the traditional financial system. But improvements to these systems can be thought of as being analogous to proposals to increase the quality of a 20th century landline telephone network to make them clearer and more reliable, as opposed to recognizing the opportunity for cellphone and smartphone networks to leapfrog those legacy systems using 21st century technology.

E. Eliminate Regulatory Barriers That Prevent Access to Financial Products That Could Make Invisible Consumers Visible

Regulators should and reconsider legal and regulatory barriers that indirectly interfere with becoming a scorable consumer by depriving lower-income, higher-risk, and younger consumers by depriving them of entry-level financial products that can enable them to establish a credit report.

1. Eliminate Restrictions on Subprime Credit Cards

A major reason that many consumers are credit invisible is because they simply have not had an opportunity to establish their credit or have damaged credit that they would like to have an opportunity to repair. Yet options are limited for mechanisms to do so. For many consumers, access to credit cards can provide a first step on the ladder to establish or reestablish credit. In fact, according to one recent survey, the most commonly stated reason (62 percent of respondents) for consumers wanting to have a credit card is "To build credit history."[398] According to a 2017 CFPB Report, 37.6 percent of newly

[398] *See* The Ascent, *Why Swipe? American Credit Card Preferences and Habits by Generation*, FOOL.COM (Mar. 5, 2019), *available in* https://www.fool.com/the-ascent/credit-cards/articles/study-why-swipe-american-credit-card-preferences-and-habits-by-generation/.

credit visible consumers used a credit card as an "entry product" to become credit visible.[399] For new or subprime consumers, however, credit cards can be extremely difficult to obtain.

Congress should examine and potentially reconsider provisions in the Credit CARD Act that limit issuance of "subprime" credit credit.[400] Subprime credit cards are cards that have low initial credit limits, such as $300 to $500, and interest rates that are comparable to the industry average. Unlike prime credit cards, which are designed to serve transactional and borrowing functions, a primary function of a subprime credit card is as a product to establish or rebuild credit while also providing an electronic transactional device. Under the terms of subprime credit card agreements, a consumer that makes regular payments on their card for a certain period, usually 12 months, become eligible to transition out of the subprime card into a regular card. Marketing materials prominently promote that the card is available to those with no credit history or a low credit score, that the card issuer will report payment performance to the three national credit reporting agencies, that the customer will gain free access to their credit score reports, and that the issuers will regularly evaluate the account for potential increases in credit lines depending on account performance. Subprime credit cards are plainly not intended or marketed to be long-term solutions to a consumer's financial challenges but instead are marketed as a transitional product to establish or reestablish

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[399] *See* CONSUMER FINANCIAL PROTECTION BUREAU OFFICE OF RESEARCH, CFPB DATA POINT: BECOMING CREDIT VISIBLE 15 (2017) (finding that only 5 percent of previously credit invisible consumer who used a credit card as an "entry product" to become credit visible used secured cards and less one percent of those under the age of 25 used secured cards).

[400] *See* DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at 357-59 (discussing subprime credit cards). Chapter 12 discusses various provisions of the CARD Act that create obstacles to younger consumers obtaining a credit card and establishing credit.

credit. In fact, many subprime credit card customers were able to improve their credit bureau scores and qualify for prime credit after a short period of time.[401]

Subprime cards can either be secured or unsecured in nature. For a secured credit card, the cardholder deposits several hundred dollars with the issuer, which can be used as collateral to offset any losses if the consumer defaults. The size of the available line of credit is typically capped at the size of the initial deposit. The issuer typically retains any interest earned on the collateral and the collateral deposit is held by the issuer until the account is closed or the consumer is eligible to refinance into an unsecured card. Secured subprime credit cards typically offer lower interest rates and lower upfront and annual fees than unsecured subprime cards; in fact, the interest rate on a secured subprime card is often lower than for a mainstream credit card. On the other hand, in order to obtain a secured card the consumer must come up with a substantial up-front deposit and must agree to keep that money locked up for a set period of time.

For an unsecured credit card, processing and annual fees were often high relative to the amount of the available credit line that was granted. For example, prior to the enactment of the CARD Act, which limited initial fees to 25 percent of the credit line granted, the initial available credit on a $300 credit line might be restricted by a $19 processing fee and a $75 annual fee, leaving an available credit line of $206. Interest rates on unsecured subprime cards are higher than for secured cards and usually slightly higher than mainstream credit cards, but still far below the triple-digit pricing of the alternative financial products described in chapter 5. Although fees and interest rates are higher than for secured credit cards, subprime consumers will often prefer an unsecured

[401] *See* DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at 358.

card because of the challenge of coming up with sufficient liquidity to make a large upfront deposit and then to keep that liquidity frozen for the duration of the card term.[402] Because of these constraints, many subprime consumers will be unable to qualify for a secured card or will find secured credit cards to be undesirable.[403] Because no security deposit is required on an unsecured card, the consumer can refinance out of the subprime card at any time and after several months of successful payments could improve their credit score and become eligible for a lower-priced card from the same or other providers.

The unusual terms of unsecured subprime credit cards, and the fact that subprime credit cards exist at all, reflects the unusually high cost and risk associated with subprime credit card operations. Rejection rates on applications are high, imposing costs on the issuer in terms of verification and processing. Loss rates from defaults and delinquencies are exceedingly high, as would be predicted in dealing with a group of high-risk consumers. Moreover, subprime issuers face an adverse selection problem—because of the nature of the product, those consumers who establish themselves to be reliable payers will improve their credit scores rapidly and have the opportunity to refinance out of the subprime card into a less-expensive card, leaving the remaining pool to be dominated by poor risks and narrowing the pool of reliable customers from which losses from delinquent customers could be recouped. Subprime credit card customers also used

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[402] *See Best Subprime Credit Cards—March 2020*, BANKS.COM (Mar. 12, 2020), *available in* https://www.banks.com/articles/credit/credit-cards/subprime-credit-cards-march-2020/ ("When you are hesitatnt to tie up a portion of your personal savings without a "set" date to retrieve them should you need them, an unsecured subprime credit card may be a better option [than a secured subprime card].").

[403] *See* CONSUMER FINANCIAL PROTECTION BUREAU OFFICE OF RESEARCH, CFPB DATA POINT: BECOMING CREDIT VISIBLE 15 (2017) (finding that only 2 percent of previously credit invisible consumers used a secured credit card to become credit visible and only 5.6 percent of those who used a credit card as an "entry product" to become credit visible used a secured card).

virtually all of their available credit (98 percent) and defaulted early in their term (about three-fourths of charge-offs occurred within the first three months) thereby imposing high losses on the issuer.[404] The unusual pricing structure of unsecured subprime credit cards reflects these economic realities. High upfront fees are necessary to offset the high cost and risk associated with these loans.

The CARD Act placed new limits on unsecured subprime credit cards, capping upfront fees at 25 percent of the initial credit line. Following the enactment of the law, subprime credit card issuance and lending declined.[405] In addition, interest rates on subprime cards rose and credit limits fell. As a result, consumers have lost access to one potentially useful tool for establishing a credit record or repairing their credit. As described, secured subprime cards are not a viable or desirable alternative for many consumers as they require substantial upfront security deposits and a willingness to keep those funds locked up for some period of time.

The opinion of the Taskforce is that Congress should reconsider the price controls imposed on subprime credit cards by the CARD Act so as to make this option available once again to a wider range of consumers. The Taskforce acknowledges the concerns of those who supported this provision of the CARD Act that upfront fees on these cards are high. But these are intended to be transition products designed to enable consumers to prove their creditworthiness and to transition to less-expensive products, not a permanent solution to the consumer's needs. For many credit invisible and unscorable consumers there are limited alternative options that are viable for them to establish credit records. The Taskforce can see no reason why the terms of these cards should be treated any

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[404] *See* discussion in DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at 358, n. 11.
[405] *See* Han, Keys, and Li, *supra* note 341.

different from other credit cards, requiring transparent and accurate disclosure of their terms and conditions instead of dictating the substantive terms of the contract.

2. Encourage the Use of Alternative Data and Artificial Intelligence in Credit Underwriting

Regulators should continue to encourage the use of reliable alternative data and artificial intelligence underwriting techniques designed to expand credit offerings to traditionally underserved consumers. Data useful for cash-flow underwriting has been shown to be a particularly promising source of new information to promote financial inclusion beyond traditional credit reporting information. Potential new furnishers such as landlords, utilities, and others should be encouraged, where possible, to furnish information to credit reporting agencies. It is obvious that consumers with limited or nonexistent credit records are those who will benefit the most from using alternative data to underwrite credit offerings. The benefits of alternative data and artificial intelligence in promoting competition and innovation are discussed in chapters 8 and 9 and it is not necessarily to reprise those observations here. It is sufficient to observe for current purposes that allowing credit issuers to use alternative data to underwrite loan offerings can benefit consumers directly by allowing them to access products that they could not otherwise. There is now a voluminous body of research that identifies the substantial benefits to consumers from the use of alternative data, artificial intelligence, and other Fintech innovations in credit underwriting.[406] In addition, by issuing an initial loan that

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[406] For a recent thorough literature review of academic studies discussing the benefits to consumers from Fintech innovations, *see* Franklin Allen, Xian Gu, and Julapa Jagtiani, *A Survey of Fintech Research and Policy Discussion*, FEDERAL RESERVE BANK OF PHILADELPHIA RESEARCH DEPARTMENT WORKING PAPER WP 20-21 (June 2020).

otherwise would not be made, the consumer can establish a payment history that, in time, will allow the consumer to build a traditional credit record.

In recent years, the credit scoring industry has continued to explore ways of enabling financial services providers to continue to expand access to more and more Americans. As discussed below, tens of millions of Americans lack credit scores completely or are "thin-file" consumers who lack sufficient information (or sufficiently recent information) to be able to be accurately scored. This problem substantially interferes with their ability to gain access to mainstream financial products. Creditors and credit reporting agencies have responded by developing new or improved credit scoring models that make use of alternative or non-traditional data, primarily data on recurring payments that are not captured in traditional credit-scoring models. Of particular interest has been to look to payments on obligations such as rent, utilities, and insurance premiums.[407] A 2012 study found dramatic increases in credit scores for thin-file consumers as a result of including utility and telephone payment data in their credit files. Twenty-five percent of thin-file consumers experienced an improvement in their credit scores while only six percent were downgraded. Low-income, minority, and those consumer who rent experienced the greatest positive effect from the inclusion of alternative data.[408] Underwriting models based on a consumer's cash-flow data also have been recognized as having particularly large potential to increase inclusion for many

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[407] DURKIN, ET AL., *supra* note **Error! Bookmark not defined.**, at 228.
[408] *See* MICHAEL A. TURNER, PATRICK D. WALKDER, SUKANYA CHAUDHURI, AND ROBIN VARGHESE, A NEW PATHWAY TO FINANCIAL INCLUSION: ALTERNATIVE DATA, CREDIT BULLDING AND RESPONSIBLE LENDING IN THE WAKE OF THE GREAT RECESSION (2012).

consumers.[409] Use of alternative data for credit underwriting purposes also received a dramatic boost during the 2020 SARS-COV-2 pandemic when the flow of traditional credit reporting data was interrupted by various moratoriums on mortgage payments, other debt payments, collections, and other traditional indicia of credit risk.[410]
In one study, economists Julapa Jagtiani and Catharine Lemieux examined the use of alternative data to make loan decisions by the fintech company LendingClub.[411] The authors found that over time LendingClub had increased its reliance on nontraditional alternative data relative to traditional FICO scores in making underwriting decisions while maintaining strong predictive loan performance in their portfolio. They also concluded "The use of alternative data has allowed some borrowers who would have been classified as subprime by traditional criteria to be slotted into 'better' loan grades, which allowed them to get lower-priced credit."[412] In a separate paper, the authors found that LendingClub's consumer lending activities penetrated areas that were underserved by traditional banks and which suffered from sub-optimal credit supply, such as those win highly concentrated markets and areas with fewer bank branches per capita.[413]

Use of traditional credit scoring for loan underwriting and pricing also appears to have a disparate impact on immigrants.[414] This appears to be because recent immigrants,

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[409] *See* FINREGLAB, THE USE OF CASH-FLOW DATA IN UNDERWRITING CREDIT: EMPIRICAL RESEARCH FINDINGS (July 2019), *available in* https://finreglab.org/wp-content/uploads/2019/07/FRL_Research-Report_Final.pdf.
[410] FINREGLAB, DATA DIVERSIFICATION IN CREDIT UNDERWRITING: RESEARCH BRIEF (Oct. 2020).
[411] *See* Julapa Jagtiani and Catharine Lemieux, *The Roles of Alternative Data and Machine Learning in Fintech Lending: Evidence form the LendingClub Consumer Platform*, FEDERAL RESERVE BANK OF PHILADELPHIA RESEARCH DEPARTMENT WORKING PAPER WP 18-15 (Jan. 2019) (finding increased reliance on nontraditional alternative data by fintech lenders relative to traditional FICO scores and
[412] *Id.* at 12.
[413] *See* Julapa Jagtiani and Catharine Lemieux, *Do Fintech Lenders Penetrate Areas That Are Underserved by Traditional Banks?*, FEDERAL RESERVE BANK OF PHILADELPHIA RESEARCH DEPARTMENT WORKING PAPER WP 18-13 (Mar. 2018).
[414] *See* FEDERAL RESERVE BOARD, REPORT TO CONGRESS, *supra* note 118, at 47.

regardless of age, lack sufficiently seasoned credit records[415] and as a result "resemble those of younger individuals, whose credit performance tends to be poor relative to the rest of the population."[416] According to a study by the Federal Reserve, these immigrant consumers are likely to benefit from greater use of nontraditional data such as rest, cash flow history, recurring bill payments, and credit histories in their countries of origin could provide additional helpful information that would increase access for these consumers.[417] Financial regulators should examine and consider reforms that would make it easier for recent immigrants to gain access to financial services more readily.

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[415] *Id.* at p. S-5.
[416] *Id.* at p. S-2.
[417] *Id.*