

IT'S TIME FOR POSTAL BANKING



The USPS should help extend banking services to the unbanked population.

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One of the biggest problems in banking today is the large and ever-increasing population of the unbanked – those who are not gaining the benefits of the regulated banking system and must rely on high-cost fringe lenders to do simple transactions like cash their paychecks. The Federal Deposit Insurance Corporation and the Consumer Financial Protection Bureau have listed this problem as a top agenda item.¹ After decades of unsuccessful regulatory proposals, the solution may finally be at hand.

On January 27, 2014, the Office of the Inspector General of the U.S. Postal Service (USPS) released a white paper that proposed that the USPS consider offering financial services to the underbanked.² Senator Elizabeth Warren has also publicly expressed support for the idea.³

The proposal was immediately criticized by the banking industry as “the worst idea since the Edsel.”⁴ The main stated concern is that the Post Office lacks the institutional capacity to provide financial services.⁵ But anticompetitive concerns – namely that a large, well-funded competitor will cut into banks’ business – likely play a role too, as they did in 2005 when Walmart attempted to obtain a banking charter.⁶

As I have written previously,⁷ and banking-industry concerns notwithstanding, the USPS is in a unique position to provide much-needed financial services for the large population of unbanked or underbanked Americans.⁸

First, the Post Office can offer credit at lower rates than fringe lenders by taking advantage of economies of scale as well as its position in the federal bureaucracy. Second, it already has branches in many low-income neighborhoods that have been long deserted by commercial banks. And third, people at every level of society, including the unbanked, have a level of familiarity and comfort with the

Post Office that they do not have with more formal banking institutions.

This essay moves one step further by demonstrating why government support and even subsidies to enable postal banking in the United States are appropriate and justifiable.

First, banking-related subsidies are grounded in historical practice, as demonstrated by government support for credit unions, savings and loans, and student loan associations. Postal banking derives from these longstanding practices, but broadens the scope to include the poor, not just the middle class.

Further, state support of banking throughout U.S. history has operated much like a social contract: the state supports the banking system in a variety of ways and, in return, banks serve as credit intermediaries, providing the populace with access to loans and financial services. Thus, subsidies for banking have been justified because they provide a benefit to all citizens.

Mainstream banks have met part of their obligation, but a large portion of the population, namely the poor, has been left out. It is time, then, for the government itself to meet the demand for credit.

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I. How the Post Office Can Bank the Unbanked

The unbanked and underbanked population in the United States is significant, with far-reaching consequences.

Approximately 88 million people in the United States, 38% of the population, are unbanked or underbanked.⁹ Indeed, nearly half of U.S. adults could not access \$2000 within thirty days to respond to an emergency.¹⁰

To meet their short-term credit needs, these individuals and families must rely on payday lenders, check cashers, or other fringe banking institutions. These lenders are often usurious, sometimes predatory, and almost always much worse for low-income individuals than the services offered by traditional banks to their customers.

For instance, the average annual income for an unbanked family is \$25,500, and about 10% of that income, or \$2412, goes to the fees and interest paid to access credit or other financial services – services that those with bank accounts often get for free.¹¹ Cutting down these payments would help many avoid bankruptcy; those who filed for bankruptcy in 2012 were, on average, just \$26 per month short of meeting their expenses.¹²

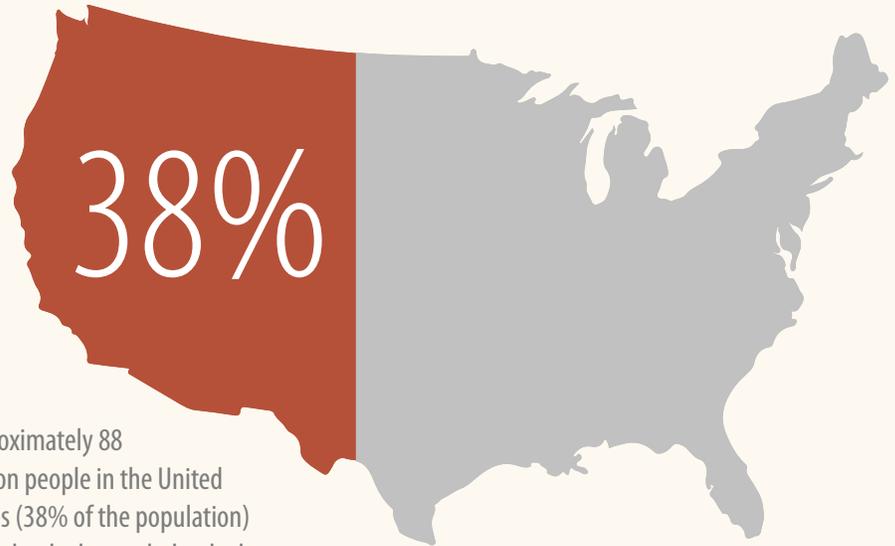
The Post Office can address this problem and lower these credit costs for the three reasons outlined below.



A. ECONOMIES OF SCALE

There are economic justifications for charging higher interest rates to those with lower incomes. The poor pay more for credit than the middle class because they are more likely to default and lenders must be compensated for assuming this risk. In other words, those least likely to be able to pay their debts are charged a premium for that inability.

But even assuming that the risk presented by low-income borrowers is accurately priced by fringe lenders (a proposition that the available data does not strongly support¹³), the Post Office can still provide these services at a lower price. In fact, the



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USPS white paper claims that the Post Office could offer a \$375 loan with interest and fees totaling \$48, as opposed to \$520 for the average payday loan for that amount.¹⁴

This discount is possible because the Post Office is able to operate with less overhead than fringe lenders and because it can benefit from economies of scale. It could reduce costs by using its existing infrastructure and clientele.

In addition, its collection costs could be lower because it may be able to enlist the help of the IRS and other federal enforcement mechanisms that can easily garnish wages or tax returns.¹⁵

It can also offer smaller individual loans that yield smaller margins by doing so at a greater volume.

B. PROXIMITY

Moreover, the Post Office is uniquely positioned to solve the problems of credit access for the poor because Post Offices remain in the low-income neighborhoods that banks abandoned.

The banking industry underwent a significant transformation during the 1970s and 1980s as mainstream commercial banks faced increased competition from other financial institutions. This market pressure on traditional banks was a result of technological advances coupled with swift deregulation.¹⁶

Forced to compete, banks shed their less-profitable products, namely small loans to lower income communities. The

poor may need banks, but the reverse is certainly not true.

Many mainstream banks hold the position that “[p]roviding financial services to the poor is fundamentally unprofitable.”¹⁷ Assuming the same risk of default, it costs a bank roughly the same amount of overhead and transactional costs to lend \$1000 as it does \$100,000, with the latter yielding a greater profit.

In pursuit of higher profit margins, banks closed branches in lower-income neighborhoods en masse. And once they did, the fringe lenders moved in.¹⁸ Thus, a significant barrier to banking the poor is the dearth of bank branches in low-income areas.

Chartered banks are regulated by state and federal laws and therefore have usury limits, or interest rate caps, on the loans they can offer. Fringe lenders do not. Once the regulated banks left these communities, so did reasonable interest rates.

For decades, banking regulators and advocacy groups have been trying to lure mainstream banks back to these neighborhoods through legislation and agency action, using both carrots and sticks.¹⁹ These efforts have not succeeded and have faced significant industry opposition.

Post Offices, on the other hand, have always been a part of nearly every zip code across the country. This fact, above others, makes postal banking a uniquely appealing idea.



C. FAMILIARITY AND COMFORT

The third major advantage of postal banking is that Post Offices provide a more welcoming atmosphere, overcoming many cultural barriers that lead the poor to avoid banks. Analyzing the demographics of the unbanked while controlling for income reveals that there are racial and cultural barriers that keep many people away from banking.

For example, more blacks and Hispanics are unbanked than whites, as are more women than men.²⁰ Many of the unbanked report being more comfortable in fringe banking institutions than in banks.²¹

Payday lenders deal behind a facade of informality. They operate in cash, in the direct vicinity of their customers, and usually in their language. This business model seems to be in direct contrast to banks with their rigid hours, requirements, and procedures.

While the Post Office will not be able to overcome all of these barriers, its branches are more accessible places than commercial banks because of their presence in low-income neighborhoods and their informality. The Post Office is not an intimidating institution; the poor know its location and understand its processes.

For all the Post Office's flaws, rich and poor across the country are familiar with its locations and often even the postal employees behind the counter.²²

To be sure, there are private institutions with similar capacities, but they are not likely to provide a solution anytime soon.

Walmart, for example, recently started offering simple financial services, such as check cashing and prepaid cards, at a discount to its customers.²³ However, the retail giant, having been definitively denied a banking charter, cannot offer credit – the most-needed financial product.

The postal system, in contrast, is well positioned to overcome most of the hurdles to banking the poor due to its ability to take advantage of economies of scale, its presence in poorer neighborhoods, and its long-standing relationship of trust with all of America's communities.

II. Why the U.S. Government Should Support Postal Banking

The opposition to postal banking is likely to center on the idea that this service functions as an inappropriate federal subsidy to the poor. But any direct or indirect subsidy of banking access for the poor is supported both historically and theoretically.



A. HISTORICAL SUPPORT

Postal banking is not unprecedented in the United States. In 1873, President Grant's Postmaster General proposed a government-sponsored savings program, modeled after one started in Britain.²⁴

In 1910, President Taft responded to growing populist proposals to establish a government-backed savings system for recent immigrants and the poor.²⁵ The Postal Savings System was created to enable the poor to save money with the assurance of a government guarantee that their deposits were protected.²⁶

This program was created and geared to recent immigrants and the unbanked poor, and was wildly successful: at the end of the first year, there was a total of \$20 million in deposits, "most of which had been coaxed out of hiding."²⁷

The director of postal savings, Carter Keene, declared in 1913 that the postal savings system was not meant to yield a profit: "Its aim is infinitely higher and more important. Its mission is to encourage thrift and economy among all classes of citizens. It stands for good citizenship and tends to diminish crime. It places savings facilities at the very doors of those living in remote sections, and it also affords opportunity for safeguarding the savings of thousands who have absolute confidence in the Government and will trust no other institution."²⁸

Throughout American history, there have been various state-supported attempts to meet the banking needs of the poor – both for depositary services and credit. Policymakers have largely recognized that access to financial services and credit

is a significant step toward individual economic advancement.²⁹

Credit gives the poor the ability to absorb financial reversals, the means to start or expand a small business, and the capacity to build a financial cushion to withstand individual economic shocks.³⁰

Several studies have demonstrated that when poor communities are provided access to credit and other banking services, they thrive economically.³¹ Studies also show that small-scale credit leads to increased income and savings among borrowers.³² The converse is also true: barriers to credit significantly hamper the economic development of poor communities and individuals.³³

For most of this country's history, the credit needs of the poor and middle class were met by banking institutions specifically created and designed to appeal to them, such as credit unions, savings and loan associations, and the smaller Morris Banks.³⁴

Credit unions were a populist innovation designed as cooperatives not only to provide access to credit, but also to provide federal insurance to protect investments.³⁵

Savings and loan associations (S&Ls) were formally created in the 1930s to offer affordable mortgage loans to lower- and middle-class people.³⁶ These institutions began as cooperatives with shared ownership, a structure that led to the forbearance of profit.³⁷

In contrast, the little-known Morris Bank was a for-profit banking venture aimed at the "democratization of credit," created to give the poor increased access to credit.³⁸

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Credit unions, S&Ls, and Morris Banks were alternatives to mainstream banks, but they were all supported and subsidized by the federal government through targeted regulation and deposit insurance protection.³⁹

As described above, banking forms homogenized in the 1970s and 1980s, leaving little room for variation in institutional or regulatory design.⁴⁰ Eventually, each of these institutions drifted from their initial mission of serving the poor and began to look more like commercial banks, even competing with them for ever-shrinking profit margins.

The result now is essentially two forms of banks: regulated mainstream banks that seek maximum profit for their shareholders by serving the needs of the wealthy and middle class, and unregulated fringe banks that seek maximum profits for their shareholders by serving the banking and credit needs of the poor.

What is missing from the American banking landscape for the first time in almost a century is a government-sponsored bank whose main purpose is to meet the needs of the poor. Rather than relegating the poor to fringe banks, policymakers should carve out a place for banks that serve the poor and enable them to survive and thrive. This charge has deep historic roots in U.S. banking.

B. THE NORMATIVE CASE

As I have written elsewhere, the state has always had a social contract with its banks, which at times has been explicit and at times implicit, but always with the same understanding: the state provides banks with public trust (through insurance and implicit bailouts) – trust that is necessary for their survival; in return, banks provide much-needed credit, savings, and financial intermediation services for individuals and institutions.⁴¹



Currently, a few large and powerful banks, who continue to benefit from trillions of dollars of federal government subsidies, control the majority of assets in the banking sector and also the majority of credit.⁴² And this credit is not reaching the poor.⁴³

If the banking system is to be supported by the government, the entire citizenry should be able to access its services.

Insofar as a heavily subsidized banking sector is the status quo and that sector does not benefit the entire population, a government subsidy to lend to the poor simply provides another mechanism for reaching the same policy goals. And if the banks benefiting from subsidies are no longer taking up the task, the government should do so directly.

The federal government subsidizes other credit products to achieve important policy goals but, thus far, these programs have been primarily designed for the middle class.

The government sponsors and underwrites private student loans. A student borrower who qualifies for such a loan receives credit at a below-market interest rate and remains indebted to the government until the loan is paid off. The government supports such loans because they facilitate an important public objective – educating the population.

The government also creates and supports a secondary mortgage market to promote the policy goal of increased home ownership.⁴⁴

Enabling the poor to escape poverty is no less important a public concern. Offering good credit to the poor would enable economic mobility, which has lagged significantly in the United States in recent years, and solve a variety of other public problems linked to entrenched poverty.

Given the recent debacles of federally funded institutions such as Fannie Mae and Freddie Mac,⁴⁵ the federal government would have to be cautious in taking on risks associated with lending to the poor. However, these services do not entail the scope of risks

associated with home mortgages. Cashing a check for a small fee or offering a payday loan often involve much less risk.

After the recent global financial crisis, any call for easing credit of any kind is suspect because of the widespread, yet inaccurate, belief that the financial crisis was precipitated by an overabundance of consumer access to mortgage credit.⁴⁶ Therefore, the case for increasing consumer access to credit is a politically difficult one to make.

However, the status quo is not sustainable as onerous interest rates make it much more difficult for individuals to escape poverty and growing income disparity has various negative economic effects.⁴⁷

Bank credit not only allows the economy to grow wealth, but also allows individual families to do so. Any difference in credit access undermines the justifications for state support of banks.

Insofar as economic mobility is a social good, and credit is a necessary tool for economic advancement, government policies should be aimed at enhancing access for all individuals and communities. Access to safe credit is crucial in allowing the poor to escape poverty.

C. A CASE FOR CAUTION

One thing that could undermine postal banking would be inappropriate profit-seeking. Attempts to regulate the private market have demonstrated that institutions with an eye toward profit maximization have been unable or unwilling to meet the credit needs of the poor.⁴⁸

In February 2008, the FDIC began the “Small-Dollar Loan Pilot Program,” a two-year campaign to enlist mainstream banks to lend to the poor.⁴⁹ The project was described as “a case study designed to illustrate how banks can profitably offer affordable small-dollar loans as an alternative to high-cost credit products, such as payday loans and fee-based overdraft protection.”⁵⁰

The program, which enlisted twenty-eight volunteer banks, was a failure. A congressional review committee noted that banks were charging the maximum rates



Income disparity is greater in the United States than ever before ...



allowed in the program – 36% APR and 20% charges on cashed checks, which were not much better than payday loans.⁵¹

The main reason this program failed is that mainstream banks do not have the incentive to sacrifice profits to meet the needs of the poor. They must survive and stay profitable in a competitive banking market, and when they offer low-cost loans to the poor, they lose their competitive position and hurt their bottom line.

Policymakers misunderstand the nature of mainstream banks if they are relying on them to adequately meet the needs of the poor.

At best, banks can be incentivized to meet the poor’s banking needs merely to appease regulators. The products the banks offer are not innovative fruits of market research about what the poor really need – the banks offer the bare minimum so that they can maintain profitability while fulfilling a regulatory mandate.⁵² Forcing banks, whose purpose is to maximize profits, to make loans to the poor will inevitably lead to inadequate loans and disgruntled bankers.

Credit unions, S&Ls, and Morris Banks, in contrast, were able to successfully reach the poor because doing so was their primary goal. And so it must be with the Post Office.

There is a troubling statement in the USPS white paper on this front. The paper states that providing these services “could result in major new revenue for the Postal Service.”⁵³ This motive cannot be the driving force behind this endeavor or else, as the pilot program example proved, it is unlikely to reach the goal of offering the poor the credit that they need.

This is not to say that the venture will not be a major new revenue source for the USPS. And the competition provided by the government entering this sector could possibly drive prices down in the private fringe banking sector to more accurately reflect the risks of lending to the poor.



III. Conclusion

Income disparity is greater in the United States than ever before, and the banking industry is more heavily subsidized than at any point in U.S. history. The result should be an increase in credit to those who most need it.

Unfortunately, the reverse is happening – the poor have been excluded from the credit flowing from the subsidized banking sector. Any efforts at forcing that sector to provide credit to the poor have failed because they are institutionally designed to maximize profits and lending to the poor is not conducive to profit maximization.

It is time for the government to step in and solve this market mismatch. The USPS is far from the most efficient or successful government agency, but it may just be the perfect institution to accomplish the monumental undertaking of providing the credit the poor need to escape poverty.

END NOTES

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- 7 Mehrsa Baradaran, *How the Poor Got Cut Out of Banking*, 62 Emory L.J. 483 (2013).
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- 10 See *An Examination of the Availability of Credit for Consumers: Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Servs.*, 112th Cong. 141 n.1 (2011) (prepared statement of Robert W. Mooney, Deputy Director, Consumer Protection and Consumer Affairs), available at www.gpo.gov/fdsys/pkg/CHRG-112hhrg72606/pdf/CHRG-112hhrg72606.pdf; see also Annamaria Lusardi et al., *The Brookings Institution, Financially Fragile*



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12 *Id.* at ii, 14.

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16 *See* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. Ill. L. Rev. 215 (explaining the shifts in banking during this time).

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