A PUBLIC BANKING OPTION

As a Mode of Regulation for Household Financial Services in the United States

REPORT BY **THOMAS HERNDON** AND **MARK PAUL**

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Executive Summary

To foster a more inclusive and accessible economy and society for all communities in the U.S., the public provision of banking goods and services by the government is an important—and bold—option to consider. Banks today are increasingly consolidating branch locations, while also moving away from low-cost financial services to high-profit activities, leaving marginalized Americans underserved and left behind. Without access to basic banking services, such as checking and savings accounts or small loans, consumers are vulnerable to a host of financial abuses. In response, this paper argues for the public provision of household financial services.

In particular, we argue for a public banking option that would directly compete with the outsized (and often predatory) power of the private household financial services sector. Such an option would have two primary components. First, the federal government would directly provide households with basic transaction services and consumer credit. This would ensure that all communities have access to basic financial tools, such as checking and savings accounts, check cashing, direct deposit, and online banking, as well as to small loans, auto loans, and mortgages.

Second, the public bank would manage an online financial services marketplace, creating an environment where public and private financial goods would directly compete alongside each other. This second component would serve as a powerful regulatory tool by allowing the government to condition sellers' access to the marketplace based on certain consumer safety standards. Consumers could also rate and review sellers, allowing easier detection of consumer abuses. A public banking option structured with these two components would create the financial infrastructure required for universal service, while also preventing consumer financial protection abuses through public-private competition.

Introduction

The purpose of this paper is to discuss the mechanisms through which a public option for consumer finance could provide a powerful tool to reduce financial exclusion and regulate consumer protection abuses such as predatory lending. A public option as a mode of regulation is defined as the government using the direct provision of services to households and intermediaries as a tool to regulate in the public interest. The public option explored in this paper would include two basic components. First, the U.S. federal government would create a public bank that directly provides households with basic transaction services and consumer credit. Second, the public bank would directly provide intermediaries with a service, through managing an online financial services marketplace where public products would compete alongside private products. We will describe in detail how the direct provision of each of these services would create the infrastructure for universal access and help improve consumer financial protection by giving the government powerful tools for risk management.

A growing body of research has convincingly shown that a large fraction of the U.S. population is currently excluded from access to basic, safe, and low-cost financial services (Baradaran 2014; Baradaran 2015). In 2015, roughly 7.0 percent of U.S. households were **unbanked**, defined as lacking a checking or savings account at an insured financial institution. However, this figure understates the problem because a large portion of the population is **underbanked**. This is defined as having a bank account, but still having to rely on high-cost alternative financial services (AFS), such as payday lenders, check cashing, money orders, pawnshop loans, international remittances, or auto title loans. In 2015, there were an additional 19.9 percent of households that were underbanked. In total, nearly 27 percent of U.S. households are unbanked or underbanked, and thus do not have their basic financial needs met by the traditional financial service industry (FDIC 2015). Being excluded from full access to mainstream financial services is expensive, with the average household that lacks access spending nearly 10 percent of their income on fees related to financial services. Financial exclusion is also disproportionately experienced by low-income and minority households, so the high cost of accessing the basic financial services necessary to participate in the economy reinforces economic and racial inequality.

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Another significant issue with the use of AFS—of which the public option would provide powerful tools to regulate—is that many employ predatory lending and service structures, in the sense that they trap borrowers in debt that cannot be repaid. The structure of predatory loans, such as payday loans, are designed to require the borrower to constantly rollover existing debt or to take out new loans to remain solvent, in order to generate high-fee revenue for the lender. These services thus concentrate risk on borrowers by making them dependent on external finance for solvency. Moreover, this is an appropriate matter for regulation, rather than a purely private arrangement, because increasing the financial fragility of borrowers increases macroeconomic instability as well. Indeed, new mortgage products that concentrated risk on borrowers made a significant contribution to the large declines in output during the Great Recession (Mian and Sufi 2014; Taub 2014; Levitin and Wachter 2013; Commission 2011).

We propose a public option as a mode of regulation in part because the U.S. already has extensive historical experience with using the public option as a tool to increase access to affordable financial services that shield households from risk. Indeed, public options were essential to the New Deal era financial reforms, even if they were rarely explicitly acknowledged as such (Levitin and Wachter 2013). Moreover, it was only after the dismantling of New Deal era public options that the twin problems of financial exclusion and predatory lending reemerged. We will review this history to show how the structure of predatory lending and financial services is similar to previous unstable lending structures that were regulated successfully in the past by public options.[1] Further, public options, such as public postal banks, are currently in use in over 60 countries worldwide, and they have been shown to reduce financial exclusion (Ason et al. 2013).

Our paper seeks to contribute to the recent literature on solutions to widespread financial exclusion and consumer protection violations. The proposal in this paper is most similar to proposals for the creation of a postal banking system (Baradaran 2015; USPS 2015; Baradaran 2014). These propose that the U.S. Postal Service (USPS) could play a significant role in eliminating financial exclusion by providing basic financial services, such as deposit, bill pay, check cashing, and small loans, to households that lack access to traditional financial services at local post offices. We seek to contribute to the literature by discussing the mechanisms through which direct competition between a public option and private intermediaries would help to regulate consumer financial protection abuses such as predatory lending. These earlier proposals often sought to restrict the public option from direct competition with private banks. Instead, they focused on exclusively providing services to those not served by the traditional banking system, thus creating a "poor people's

[1] Utilizing a public option as a mode of regulating private markets, and as a means of increasing competition within those markets, is increasingly gaining traction in the United States. Recent examples include the push for Medicare-For-All and the increased support for a federal job guarantee. For a detailed treatment of the role of public options in promoting competition, see Darity Jr. and Hamilton (forthcoming).

bank.” In contrast, we argue that direct competition would provide a powerful regulatory lever that has a well-pedigreed history of successful use in the U.S.

Rampant Financial Exclusion and “Solutions” to Date

In the following section, we provide a detailed account of the two primary issues with household finance that the public option seeks to address. The first problem we discuss is financial exclusion, where households are unable to utilize traditional financial institutions to meet their everyday financial needs. We then discuss the current distribution of risk in household financial services, arguing that alternative financial services disproportionately redistribute risk onto households to the detriment of both the household and macroeconomic stability. Finally, we discuss public and private interventions to date that have tried to address these shortcomings in household financial services.

FINANCIAL EXCLUSION: THE CLASSIC PROBLEM OF INFRASTRUCTURE REGULATION

Financial exclusion is defined as households who are unbanked or underbanked in the United States, and it was first discussed during the 1990s by geographers concerned about physical access to banking services and modern payment instruments (Leyshon and Thrift 1994; Kempson and Whyley 1999). An unbanked household is a household that simply lacks access to any bank account, while an underbanked household is one in which the household has access to a bank account but is still dependent on the use of high-cost alternative financial services (AFS) to meet their financial needs. AFS include transactional services, such as money orders, remittances, and check cashing at non-banking institutions, as well as credit-based services, such as payday loans, pawn shop loans, auto title loans, and rent-to-own services. Providers that operate outside of federally insured banks and thrifts offer such services.

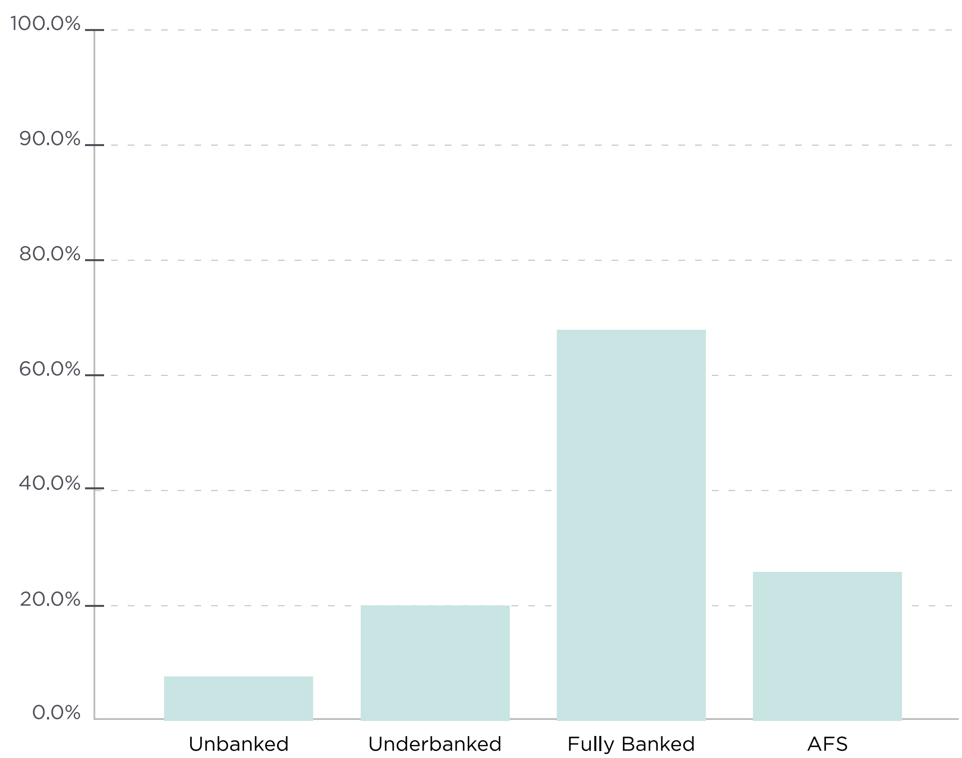
A growing body of research has convincingly documented the persistence and widespread nature of financial exclusion in the United States, which now affects one-in-four American households (Larrimore et al. 2017). Figure 1 depicts the 2015 national trends for financial exclusion through banked, unbanked, and underbanked status, as well as household use of AFS. Using data from the 2015 Federal Deposit Insurance Corporation (FDIC) National

Survey of Unbanked and Underbanked Households, we see that as of 2015, 7.0 percent of U.S. households were unbanked, and an *additional* 19.9 percent of households were underbanked. In total, nearly 27 percent of U.S. households were unbanked or underbanked, and thus were excluded from full access to mainstream financial services.

> ***A growing body of research has convincingly documented the persistence and widespread nature of financial exclusion in the United States, which now affects one-in-four American households.***

Financial exclusion disproportionately affects those already on the margins of society, such as those with low income and education. Nearly half (49.1 percent) of households whose head does not have a high school degree are unbanked or underbanked, while 15.6 percent of households whose head has a college degree are unbanked or underbanked. Similarly, income is significantly correlated with a household's banked status, with households whose income is $30,000 or under being financially excluded at a rate of 42.1 percent, while 13.8 percent of households with incomes of $75,000 and above lack financial inclusion.

FIGURE 1. HOUSEHOLDS' BANKED STATUS, 2015, NATIONAL ESTIMATES



Source: Author's calculations, 2015 FDIC National Survey of Unbanked and Underbanked Households.

Financial exclusion disproportionately affects groups who have historically experienced discrimination. For instance, black, Hispanic, and women-headed households are all more likely to be unbanked or underbanked than those headed by white males. Black households are nearly six times more likely to be unbanked than white households, while Hispanic households are nearly five times more likely to be unbanked. In all, 49.3 percent of black and 45.5 percent of Hispanic headed households are unbanked or underbanked, compared to 18.7 percent of white-headed households.

Table 1 investigates these differences in banked status across racial groups, conditional on levels of education, income, homeownership, and urban status (i.e., reside within metropolitan statistical area). Accounting for such factors across households does not seem to explain the pervasive gaps in banked status across racial groups. Even when the analysis is restricted to households with the greatest resources—those who own a home, have a college degree, *and* have incomes above $75,000—the data still indicates that black households (24.5 percent) are 2.5 times more likely to be unbanked and underbanked than their white peers (9.62 percent). These findings indicate that while banks are failing to provide universal access to financial services, they are doing a particular poor job at serving people of color in particular, even after accounting for differences in education, income, and homeownership.

TABLE 1. PERCENTAGE OF UNBANKED AND UNDERBANKED HOUSEHOLDS BY RACE

		EDUCATION		INCOME		HOMEOWNERSHIP		RESIDE IN MSA	
	Unbanked & Underbanked	No College Degree	College Degree	Below $50k	Above $50k	Yes	No	Yes	No
White	18.69	22.66	12.02	25.57	13.01	13.88	30.9	16.91	24.44
Asian	25.01	29.21	22.21	34.03	19.64	17.35	33.7	24.64	25.89
Hispanic	45.48	49.82	24.69	54.02	28.68	31.29	57.26	45.02	55.13
Black	49.29	54.84	30.6	57.54	32.34	34.41	60.45	48.53	56.91

Source: Author's calculations, 2015 FDIC National Survey of Unbanked and Underbanked Households.

We argue that financial exclusion can be seen in terms of the classic problem facing infrastructure regulation: how to ensure universal access to basic services. Infrastructure regulation has widely acknowledged that we should not expect market pricing based on marginal cost to provide universal access to necessary services, because it is not as profitable to serve low-income and low-wealth groups. To overcome this, universal service requirements have long been a classic component of infrastructure regulation. Since its inception, for example, the USPS has served routes that it knew would never be profitable because providing universal access to communications infrastructure was seen as a public priority. Additionally, many transportation and utility providers have also had universal service requirements where they were required to provide transportation and utility services to unprofitable areas, with universal access as the primary motivation (Lewis and Severnini 2017; Ricks 2018).

History shows us how financial exclusion is a persistent problem, which rapidly reemerges absent universal service requirements and hinders an inclusive, accessible economy. Universal service requirements were a key component of New Deal era banking reform, which envisioned the role of banks as similar to a quasi-public utility (D'Arista 1994). However, following the financial deregulation of the 1980s that removed the regulations that functioned in a similar manner to universal service requirements, commercial banks and other depository institutions transitioned away from offering basic, low-cost financial services in favor of pursuing higher-profit activities.[2] An example of this can be seen in the failure of traditional banks to provide small-dollar loans. Small dollar loans from these institutions have the potential to replace payday loans by providing loans to previously financially excluded households on terms that are more favorable. However, banks have shown little interest in developing small-dollar loan services, because they are less profitable than larger loans. The essential problem is that small- and mid-sized loans have similar underwriting costs, however the revenue earned by the bank is greater for the larger loan. Therefore, at the margin, we should not expect the profit-maximizing bank to be incentivized to provide small-dollar loans (Baradaran 2014).

The recent trend of bank branch closings also provides an example of how marginal-cost pricing contributes to financial exclusion by reducing access to traditional financial services in low-income communities. Bank branch closings have accelerated since the financial crisis, with roughly 5000 branch closings from 2009-2014 (Morgan et al. 2016). However, these closings have not been distributed equally. Fully 93 percent of these closings have occurred in ZIP codes with income levels that are below the U.S. median (USPS 2014; Baradaran 2013). At the most extreme, this resulted in "bank deserts," defined as a census tract in which there is no bank within 10 miles. In 2014, there were 1,132 bank deserts, 398 of which were in urban areas, and 734 of which were in rural areas. A total of 3.74 million people currently live in these "bank deserts."

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[2] Examples of regulations that served a similar role to universal service requirements will be in Section 3, and comprehensive treatments can be found in D'Arista (1994) and Levitin and Wachter (2013). A full discussion of the effects of deregulation on financial exclusion can be found in Baradaran (2013).

As the institutions that traditionally provided service to the poor have stopped offering these services, these households have no other choice than to utilize high-cost alternative financial services.

This financial exclusion comes at a sizable cost to households. As the institutions that traditionally provided service to the poor have stopped offering these services, these households have no other choice than to utilize high-cost alternative financial services. Some researchers have arrived at a relatively favorable view of AFS (Servon 2017), because this sector often provides services desired by low-income or low-wealth households that are unavailable to them through traditional financial institutions. However, the evidence reveals the reality. AFS are unlikely to improve a household's long-run financial well-being due to their high cost. For example, the average payday loan charges a 400 percent annual interest rate, compared to interest rates of between 12-30 percent for credit cards (Baradaran 2015; USPS 2014). In 2011 alone, Americans spent an estimated $8 billion on financial charges to access $50 billion in loans from payday lenders (Bertrand and Morse 2011). These expenses add up rather quickly. The fees and interest on such loans totaled roughly $89 billion in 2012, with the average household that lacks access to traditional financial services spending nearly 10 percent of their income on fees related to financial services (USPS 2014).

DISTRIBUTING RISK: PREDATORY LENDING AND MACROECONOMIC EXTERNALITIES

Another significant problem with the use of AFS is that many types of alternative lending services employ predatory structures. The FDIC defines predatory lending as 1) making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation; 2) inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced ("loan flipping"); or 3) engaging in fraud or deception to conceal the true nature of the loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower (FDIC 2007). We argue that predatory lending structures are problematic from a macroeconomic perspective because they concentrate risk on borrowers, which increases financial fragility and amplifies recessions.

For a concrete example of how predatory lending structures concentrate risk on borrowers, it will be useful to examine the structure of the typical payday loan. A payday loan is a small-dollar, short-term loan that must be repaid in full on the borrower's next payday. The single large repayment in this loan, rather than an installment structure, ensures that the borrower will not be able to repay the loan and still pay their other bills. In order to meet their obligations after repayment, borrowers require the extension of a new payday loan, or rolling over the initial loan with additional high fees, 80 percent of the time (CFPB 2014). Therefore, this structure falls under the FDIC's definition of predatory because it is designed to require the borrower to either refinance the loan or obtain a new loan. The high costs of fees and interest rates in payday lending also play a role in this structure, by increasing the repayment cost (King and Parrish 2011; Parrish and King 2009).

> ***We argue that predatory lending structures are problematic from a macroeconomic perspective because they concentrate risk on borrowers, which increases financial fragility and amplifies recessions.***

It is important to explicitly emphasize that the need for repeated payday loans is generated by the structure of the loan itself, because of the unaffordable repayment schedule, rather than any lack of thrift of the borrower. If the borrower could repay the loan in several installment payments over a longer time horizon, and at a reasonable interest rate, the borrower would not require the constant extension of new payday loans. Indeed, it should be relatively unsurprising that payday loans are designed to require repeat lending, because this is a key aspect of the business model. For example, one payday lender said, "The cycle of debt is what makes these stores so profitable." He described the typical successful store as having 400 to 500 customers, each trapped in the debt cycle with loans that they could not pay (Rivlin 2016). Research has estimated that approximately 75 percent of payday loan volume is due to this churning (Parrish and King 2011; Parrish and King 2009).

Analyzing the distribution of risk in credit contracts provides a tool for understanding how predatory lending is problematic from a macroeconomic perspective. Debt contracts are inherently distributional in that the terms of the contract specify the distribution of risks between borrower and lender. The major type of risks inherent in debt contracts can be organized into five types, which include credit, collateral, liquidity, interest rate, and pre-payment risks. Credit risk is the risk that the borrower will default on the loan. Collateral risk is the risk that the value of the underlying collateral securing the loan will decline. Liquidity risk is the risk that the borrower will require external finance at the end of the loan term. Interest rate risk is the risk that the interest rate will change during the life of the loan. Finally, pre-payment risk is the risk that the borrower will pay off the loan in full earlier than scheduled, and therefore the lender will not make the expected amount of interest on the loan.

In terms of the distribution of risk, payday lending is problematic because it concentrates liquidity risk on borrowers. This structure concentrates liquidity risk on borrowers because the borrower's ability to remain solvent is dependent on their ability to obtain external finance. This structure also makes the borrower financially fragile, because any shock to the borrower's ability to obtain external finance would drive them into insolvency. It would also be straightforward to restructure the terms of this loan to shield households from liquidity risk by extending the loan term and allowing installment payments.

The above example also shows why consumer debt contracts cannot be simply regarded as a private matter. Instead, these contracts are the proper subject of regulation because the distribution of risk between debtors and creditors affects macroeconomic stability. To the extent that terms of debt contracts concentrate risk on borrowers, borrower spending becomes more sensitive to any economic shocks. As the financial structure becomes more fragile, spending shocks become more amplified, potentially causing macroeconomic instability, such as a recession. For example, Mian and Sufi (2014) have recently argued that a form of mortgage in which collateral risk was more evenly distributed between debtor and creditor would have helped to reduce the large declines in spending associated with household deleveraging during the Great Recession and its aftermath.

WHY CURRENT "SOLUTIONS" DON'T ADDRESS FINANCIAL EXCLUSION

In this section, we review recent solutions offered to address financial exclusion in order to better situate our proposal for a public option. Recent proposals can be divided into two groups: primarily private solutions that offer minimal tweaks to the existing system and public solutions via the direct provisioning of services by the federal government. Private solutions to date include financial literacy training and financial innovations, such as high-tech payment systems, microfinance, and peer-to-peer lending networks. Public solutions through the direct provisioning of services from the government include the U.S. Department of Treasury's creation of electronic transfer accounts (ETAs) or a public bank administered through the U.S. Postal Service.

To date, private solutions have focused on bringing financially excluded households into the existing infrastructure that makes up the financial service industry. For instance, financial literacy programs largely view financial exclusion as an individual problem that can be addressed through changes to individual agency. Advocates of such a position see unbanked and underbanked individuals as excluded from the traditional financial system because they are financially illiterate, fiscally irresponsible, or lack some other required skills or attributes to acquire access to the traditional financial system. At its core, the financial literacy approach is predicated on the misguided view that financial exclusion is a choice, arising from the poor financial habits on the part of the individual—largely those who are minority (black and Latinx) and low-income (Baugh 2015).

However, this diagnosis is at odds with the evidence. Research to date does not demonstrate a causal link between financial education and financial literacy with superior financial behavior or outcomes (Willis 2009; Willis 2011). Additionally, research analyzing savings and investment patterns across racial groups finds that white households do indeed save a higher portion of their income, but that there is no difference in savings behavior once the household's income is taken into account (Gittleman and Wolff 2004). In fact, financial literacy programs may result in perverse outcomes, such as individuals taking additional risk despite no improvement in their financial management ability (Willis 2009). Moreover, financial literacy programs do not at all address the reality that the financially excluded often accept predatory loan terms due to lack of any viable alternative. However, once a borrower accepts the loan, they frequently end up trapped in a cycle of repeated lending. The fact that repeated payday lending is due to the structure of the loan itself—rather than individual financial decisions made by borrowers—strongly suggests that financial literacy programs would likely be ineffective as a solution to predatory lending or financial exclusion.

Other scholars, policymakers, and entrepreneurs have looked to innovations in private financial markets and services—commonly referred to as fintech—to address the problems of financial exclusion. Those enthusiastic about these solutions tote the power of dynamic markets, arguing that voluntary efforts by banks will sufficiently meet the needs of consumers (Seger 1989). Yet the evidence does not support this claim either. For instance, a recent development in the fintech space is peer-to-peer (P2P) lending. P2P lending platforms provide an avenue for individuals with capital to lend directly to borrowers. These platforms supposedly decrease financial exclusion through mechanisms, including: allowing borrowers to refinance expensive credit card debt; assisting borrowers in building their credit histories and increasing their credit scores; and assisting financially excluded individuals in accessing credit at more favorable rates than the predatory AFS industry (Demyanyk et al. 2017). However, rather than stemming financial exclusion, loans provided through P2P platforms largely "resemble predatory loans" (ibid.).

Other private market innovations include the promotion of new services, such as PayPal, Apple Pay, Android Pay, and millennial favorite Venmo; however, all of these systems require individuals to already have a bank account. Provided that unbanked households by definition do not have a bank account, such tech interventions are not appropriate innovations to address financial exclusion. Therefore, these high-tech solutions are really an example of "new technology on old rails," and so they do not work for people who lack access to the old rails, i.e. the mainstream payments system (Ricks 2018).

Working Towards a Better Public Solution

An alternative approach to address financial exclusion is that of the direct provisioning of financial services by the government. The degree of services and market penetration of direct provisioning could vary widely. In fact, the federal government currently provides direct financial services on a limited basis to individuals through small-scale programs, such as the ETAs administered by the U.S. Treasury Department. This program provides individuals who are receiving federal payments electronically an account that gives them access to the payments system.

More robust programs of direct provisioning have been proposed to date, with perhaps the most widely discussed being the creation of a public bank, such as a postal banking system. Researchers propose that the USPS could play a significant role in eliminating financial exclusion by providing basic financial services, such as deposit, bill pay, check cashing, and small loans, at local post offices to households that lack access to traditional financial services (Baradaran 2013; Baradaran 2015). The lynchpin product for postal banking would be a reloadable postal debit card (USPS 2015).

One of the most significant features of direct provisioning proposals is that they could address the classic problem facing infrastructure regulation. Indeed, the USPS already contains the physical infrastructure to provide universal access to financial services; simply put, there is already a post office in each ZIP code, which may make the post office well situated for providing financial services to those who currently lack it.[3] Moreover, these post office branches are unified into a single national network that is significantly larger than any private network. For example, the largest single bank branch network belongs to Wells Fargo, yet the post office has about 5.5 times more branch locations than Wells Fargo (Baradaran 2015; USPS 2014).[4]

> ***One of the most significant features of direct provisioning proposals is that they could address the classic problem facing infrastructure regulation.***

[3] The post office currently has more than 35,000 post offices, which could serve as local financial services providers. In comparison, there are roughly 95,000 bank branches in total across the country. Therefore, entry into the financial service industry by the USPS could single-handedly increase the total number of branch locations serving communities by over one third (Baradaran 2015).

[4] Commercial bank branch data from Hess (2014).

In our evaluation, the most significant shortcoming to prior proposals on public banking is that they tend to restrict the public bank from direct competition with private banks, instead focusing on serving those currently excluded from traditional banking. For example, one recent proposal from the USPS Office of Inspector General (OIG) explicitly states, "To be clear, the Postal Service should not aim to take customers away from traditional banks and credit unions" (USPS 2014). This paper aims to contribute to the literature on public banking proposals by overcoming this limitation. The central argument of this paper is that direct public-private competition in the financial service sector would provide a powerful mechanism for financial sector regulation, which will be discussed in depth in Section 4.2.

The central argument of this paper is that direct public-private competition in the financial service sector would provide a powerful mechanism for financial sector regulation.

Another drawback of competitive restrictions is that they could be so severe as to prevent the public bank from offering meaningful services, or they could even make the system obsolete. Indeed, these competitive restrictions played a large part in the demise of the original postal banking system in the United States, the United States Postal Savings System (USPSS). The USPSS operated from 1911to 1967, and it was designed to provide basic banking services to low-income, rural, and immigrant households, i.e., the most financially excluded and vulnerable (Kemmerer 1911). While a robust public option was the original intent of early versions of the legislation, opposition from the financial industry placed significant restrictions on the final bill.[5] For example, one restriction placed an interest rate cap that could be paid by the postal banks that was well below the private market rate. The postal banks would pay 2.0-2.5 percent interest on deposits and reinvest those deposits in private financial institutions, receiving higher rates on their investment than they paid out to depositors (ibid.) Additionally, low deposit limits were put in place on postal bank accounts. These restrictions essentially ensured that the postal banking system was not competitive with private services, which effectively legislated its obsolescence after the creation of deposit insurance.[6]

[5] This was initially a Republican proposal, which they intended as a more measured approach than the Federal Deposit Insurance Corporation.

[6] For an extensive discussion on the history of the Postal Savings System in the United States, see Baradaran (2015).

A Brief History of New Deal Era Public Options

Market regulations are typically thought of in terms of command and control regulations imposed from the top down, which either prohibit or require practices. However, in practice the U.S. government has often regulated markets through the direct participation of public institutions, or what we call the public option as a mode of regulation. Indeed, the U.S. government has a long history of successfully using public options to increase access to safe and affordable financial services for households. We review the history of the public options of the New Deal era to highlight how the current problems of financial exclusion and predatory lending are actually quite similar in structure to the problems that were successfully regulated during the New Deal—which suggests that they can be successfully regulated again. While this is not meant to be a comprehensive review, we will focus on how the direct provision of services to households allowed public options to set the terms of the market to shield households from risk, while the direct provisioning of services to intermediaries gave the government leverage for increasing universal access to financial goods and services.

The creation of a stable mortgage structure during the New Deal provides an excellent case study of how public options can be used to regulate in the public interest by shielding households from risk. Stable mortgages in the U.S. only emerged due to direct government intervention to address the foreclosure crisis, which contributed to the Great Depression. Prior to New Deal reforms, the structure of mortgages concentrated risk on households. These loans typically had terms of 3-5 years but were not fully amortizing, and so they required a large payment at the end to fully pay off the loan. This structure earned these mortgages the nickname "bullet mortgages" because of the large "bullet" payment at the end the loan term. Borrowers typically depended on the extension of a new mortgage at the end of the loan to prevent foreclosure (Levitin and Wachter 2013).

The creation of a stable mortgage structure during the New Deal provides an excellent case study of how public options can be used to regulate in the public interest by shielding households from risk.

The essential point for our discussion is that this loan structure had low levels of consumer protection and was financially fragile because it concentrated interest rate, liquidity, and collateral risk on borrowers. These loans concentrated interest rate risk on borrowers because if interest rates increased during the loan term, borrowers would only be able to obtain a new loan at the higher interest rate. These mortgages concentrated liquidity risk on borrowers because borrowers had to bear the risk that a new loan or other external finance would not be available at the end of the loan term, resulting in foreclosure. Finally, borrowers had to bear collateral risk also, because they would bear the first losses if the value of their home declined. The financial fragility of this structure was revealed during the Great Depression. At the height of the Great Depression in 1933, roughly one half of the mortgages in the country were in default, and 10 percent were in foreclosure.

The creation of stable mortgages occurred through the direct intervention of the Homeowner Loan Corporation (HOLC) and shows how the government can use the direct provision of services to set the terms of the market in the public interest. The HOLC was a government agency that purchased defaulted mortgages and refinanced them into a new, stable structure: fixed rate, long-term, and fully amortizing. In setting the new terms of the loans to improve stability, the government needed to redistribute the bundle of risks to shield borrowers from risk. The new mortgages significantly improved stability because they redistributed liquidity and interest risk away from borrowers and towards lenders, who had more robust tools to manage these risks. For example, the long-term, fully amortizing structure removed liquidity risk from borrowers because it did not require the extension of a new mortgage at the end of the loan term. Financial intermediaries would now have to bear greater liquidity risk than under the older loan structure with a 3-5 year term. However, they would also have more tools to manage this risk than households because they had access to liquidity from the Federal Home Loan Banks and the Federal Reserve, as well as deposit insurance. Additionally, the fixed rate shielded borrowers from interest rate risk, leaving them with stable monthly payments that they could budget around (Levitin and Wachter 2013; D'Arista 1994; Mian and Sufi 2014).

In addition to stabilizing the mortgage market, increasing accessibility and thus reducing financial exclusion was also a primary goal of New Deal era banking reform. Prior to the New Deal, most households simply lacked access to affordable mortgages. The new mortgages created by the HOLC were also more accessible than bullet loans because of the much-longer loan terms and higher allowable loan-to-value (LTV) ratios. The longer terms of 15 to 30 years lowered monthly payments to a level that was affordable for a much larger share of households. Additionally, the higher allowable LTVs of up to 80 percent, compared to the 33-50 percent before, made the mortgages more accessible by lowering the required down payment to purchase a home (Levitin and Wachter 2013).

Another key problem the government needed to solve in order to reduce financial exclusion was to increase the number of intermediaries providing financial services to communities. Prior to the New Deal reforms, roughly one third of counties simply lacked access to any provider of mortgage credit. To ensure access to financial services in all communities, the banking reforms used restrictions in charters essentially to transform depository institutions, and particularly Savings and Loans, into public utilities that provided affordable, stable credit for the communities in which they were located. These included restrictions on lines of business, branching, types of assets that could be held and in what amounts, lending beyond a specified distance from the institution, the amount of loan that could be lent to a single entity, and prohibited adjustable rate lending.

Overall, the banking reforms of the New Deal era substantially reduced financial exclusion.

From an infrastructure regulation perspective, these restrictions can be interpreted as classic universal service requirements. For example, the branching restrictions, geographic restrictions on lending, and restrictions on interstate banking were designed to ensure fair access to affordable credit for all communities, at all income levels. These restrictions were put in place due to fears that interstate branch banking would undermine access to credit by channeling deposits out of low-income, rural communities and into financial centers such as New York City. In addition to ensuring soundness by prohibiting risky behavior, restrictions on classes of assets that could be held and other activities were also designed to ensure that banks would not be diverted from their role of providing basic services in their communities, in favor of more profitable, risky services (D'Arista 1994; Levitin and Wachter 2013).[7]

This history also suggests a final note of caution: Absent regulation, financially fragile loan structures tend to reemerge rapidly.

The chartering restrictions are also significant for our discussion of the public option as a mode of regulation because they are an example of how the government can use the provision of services to intermediaries as a tool for regulating in the public interest. As an incentive for the significant restrictions, these charters also granted depository institutions access to services that stabilized their funding, such as liquidity provided by the Federal Reserve or Federal Home Loan Bank systems, and deposit insurance through the FDIC or Federal Savings and Loan Insurance Corporation. The essential dynamic was to provide intermediaries with services, but to condition the provision of these services on intermediaries accepting regulatory goals. Overall, the banking reforms of the New Deal era substantially reduced financial exclusion. For example, the homeownership rate increased

[7] To be sure, we do not see these particular restrictions as the ideal form of universal service requirement and are not proposing a return to this highly restrictive, mid-century unit banking system. Indeed, we see the large scope and scale of the government's ability to provide these services as one of the key strengths of our proposal, because it takes advantage of economies of scale. Here, we merely provide an example of how universal service requirements have a long history in U.S. banking regulation.

from roughly 40 percent prior to the New Deal, to over 65 percent in 1970 (FHLBB 1983; Levitin and Wachter 2013).

We review this history to show that the consumer financial protection problems with financial exclusion and predatory lending in AFS are actually quite similar to problems that the federal government has successfully regulated in the past through the use of public options. Indeed, in concentrating liquidity risk on the borrower, the structure of a payday loan is functionally similar to that of the Depression-era bullet loan. This history also suggests a final note of caution: Absent regulation, financially fragile loan structures tend to reemerge rapidly. Immediately following the deregulation of the financial industry in the 1980s, adjustable rate mortgages (ARMs) reemerged, which redistributed interest rate risk back towards borrowers. Many of these mortgages also redistributed liquidity risk back towards borrowers. These loans came with low initial interest rates that would eventually reset at a higher rate after an initial "teaser" period, thus requiring borrowers to refinance the loan in order to remain solvent. Due to the similarity of risks borne by the borrower, this loan structure was effectively that of the earlier Depression-era bullet loans. The performance of these loans also paralleled that of bullet loans, with the mass failures of these mortgages significantly contributing to the Great Recession (Levitin and Wachter 2013; Mian and Sufi 2014; Peek 1990).

Structure and Role of a Public Option in Banking

In this section, we describe the two institutional components of our proposal for a public banking option to successfully deliver increased, inclusive access to basic financial services: the creation of a new public bank and an online financial services marketplace. We then explain how a public option can serve as a mode of regulation, equipping the government to ensure that the financial industry acts in the public's interest.

HOW TO DESIGN A PUBLIC OPTION IN BANKING

We propose that the public option for household financial services have two primary components. First, the public option would include the creation of a new public bank, which would directly provide basic deposit and transactions services to all households, as well as "plain vanilla" consumer financial services, such as small-dollar loans, auto loans, and mortgages. Second, the new public bank would also manage an online financial services marketplace, where public services would directly compete with private services.

The first feature of the new public option would be the creation of a public bank, which would be organized as a government corporation to increase administrative flexibility. The primary difference between a government corporation and a government agency is that the government corporation is not subject to the congressional appropriations process, as government corporations are required to generate enough revenue to cover costs through the provisioning of goods and services.[8] Therefore, a public corporation has more flexibility in the design and execution of its budget (Kosar 2011). The public bank would be a member of the Federal Reserve system and be regulated by Federal Reserve and the Consumer Financial Protection Bureau (CFPB).

While we propose that the public bank be constituted as an independent agency, we also propose that the new public bank partner with the USPS to take advantage of the postal service's large geographic branch network. As described in the Section 2.3, the postal branch network already contains the physical infrastructure required for universal access: a post office in every ZIP code. Moreover, this would help counteract the trend of bank branch closings because 59 percent of post office branches are located in ZIP codes with either a single or no bank branches (Baradaran 2015; USPS 2014). Overall, we argue that partnering with USPS branch network in combination with the creation of an online financial services marketplace would provide the necessary infrastructure for ensuring universal access.

The first service directly offered to households by the public bank would be basic deposit and transactions services, which would seek to provide universal access to the payments system. Basic deposit services would include checking and savings accounts, check cashing, direct deposit, and online banking. The checking account would also include a public debit card. This card would allow online bill payments, mobile payments, e-commerce payments, and any other activity traditionally associated with debit cards. The public debit card would also allow access to a nationwide network of surcharge-free ATMs, which, for instance, could be located in post offices or other public buildings. Additionally, the public bank would offer payment products, including electronic money orders and international remittances, to meet the diverse needs of consumers. These basic deposit and payment services are similar to those proposed by the USPS OIG (USPS, 2015; USPS, 2014).

[8] It is important to note that there is a potential tension here with the mission of the public options. Government corporations must generate sufficient revenue to cover costs, but the public option is intended to provide universal access to the payments system, and it should not prioritize profitability. Further, in the USPS Office of the Inspector General (OIG) report on public banking, they view the public bank as a potential major revenue stream for the Post Office (USPS 2015). Providing universal access to low-cost services and utilizing the public bank as a source of revenue may present profound challenges.

From the perspective of addressing financial exclusion, basic deposit and transactions services should be provided free of charge. Revenue to cover operational costs for these services could be derived from lending income, similar to cross-subsidies built into universal service requirements for infrastructure. Alternatively, revenue to cover costs could also be generated by charging sellers a fee for participating in the online public financial services marketplace, described below. Ricks (2017) has also suggested that revenue to cover deposit and transactions services could be generated from seigniorage. However, if these revenue sources were not sufficient to cover operational costs for deposit services, then a modest fee could be also assessed. Providing free checking accounts and charging a fee for these services are both common in private financial institutions. Currently, 39 percent of checking accounts in commercial banks are free, and 76 percent of checking accounts in credit unions are free.[9]

The public bank would also provide a full range of plain vanilla consumer finance, including small-dollar loans, auto loans, and mortgages. These services would be similar in concept to the "plain vanilla" services proposed by the CFPB (Levitin 2012). This proposal would give the CFPB power to designate certain forms of financial products as the standard and require that lenders offer these standard services alongside any alternative services. The services designated as standard would contain transparent, affordable terms that shielded borrowers from risk; thus, they would anchor the market by serving as a point of comparison for more complex products. However, this proposal was never enacted due to opposition from lenders who did not want a regulatory agency compelling them to offer a specific type of product. Directly providing these services would play the same role of anchoring the market, while avoiding compelling intermediaries to provide these services through command and control regulation.

The small-dollar loans provided by the public bank would directly compete with, and perhaps eventually replace, AFS lenders. The loan terms could be similar to those proposed by the USPS or by the FDIC Small Loan Pilot Program. The program issued loans for $2,500 or less, with repayment terms of 90 days or greater (FDIC 2010). Additionally, we propose that once a borrower successfully repaid a small-dollar loan, they be allowed access to a small-dollar revolving line of credit. This would provide users a more flexible safety net for unexpected expenses than having to apply for each loan separately, ultimately reducing underwriting costs.

The public bank could also provide the full range of mortgages that are already guaranteed by the government, such as those guaranteed by the Federal Housing Administration (FHA) or other government-sponsored enterprises. The underwriting templates used by these

[9] Data on free checking accounts come from: http://www.bankrate.com/finance/checking/want-free-checking-check-out-credit-unions-1.aspx.

agencies have been the standard templates for mortgages since the New Deal era, and so they have a strong track record of success. Additionally, having these mortgages guaranteed by these agencies would facilitate streamlined securitization in the secondary market as agency securities. We anticipate that the bulk of mortgages issued through the public bank would be securitized to protect the public bank from risk. Finally, we also propose that the public bank should simultaneously provide a full range of other consumer financial services including consumer loans, such as credit cards and auto-loans.

In principle, we see no reason why the government would not successfully provide the full range of consumer loans directly. Indeed, public postal banks across the globe have successful experience in both directly providing these services themselves, as well as providing these services through partnerships with private providers. However, we also want to explicitly address a significant risk that the public bank will have to manage to successfully provide these services. Likely the biggest danger that the public bank could face would be to ensure that underwriting standards are not politicized, leading to an underpricing of risk. The danger of politicized underwriting is most acute for small-dollar loans, where risk-based pricing may conflict with the goal of financial inclusion. One could imagine the possibility of substantial political pressure to lower underwriting standards in an attempt to make loans more widely available. However, to the extent that these loans are made to higher-risk borrowers, such as those who do not have access to traditional financial services, they will require higher interest rates. This is one reason why interest rates are high at non-traditional lenders such as payday lenders.

> ***With these features, small-dollar loans can successfully serve in the role they are designed for—as a safety net—and not as a substitute for income policy.***

While there is potential danger, we see no reason in principle why this risk could not be successfully managed while still fulfilling the goal of financial inclusion. For example, there is also good reason to believe that the government could provide small-dollar loans at a lower cost than non-traditional lenders would, while still adequately pricing risk. The government has a lower cost structure due to 1) economies of scale, 2) lower overhead costs, and 3) nonprofit structure. Were the public bank to partner with the USPS to provide these services through the post office branch network, the government would be able to benefit from large economies of scale and lower overhead costs. These economies of scale would allow the creation of standardized underwriting templates, which would reduce underwriting costs. Importantly, not needing to generate profits would also lower costs.

In total, these cost advantages should allow the public bank to meet the goal of financial inclusion by offering these services at lower cost than currently available, while still adequately pricing risk. A further bulwark against politicized underwriting is that this institution will be organized as a public corporation, where the bank would bear first losses due to inadequate underwriting. With these features, small-dollar loans can successfully serve in the role they are designed for—as a safety net—and not as a substitute for income policy.

The second institutional component of the new public option would be to manage an online marketplace for financial services. This marketplace would allow private intermediaries to offer a wide range of financial services to households—provided that these services met high consumer protection standards. Services from the public bank could also be offered through this marketplace and directly compete with private services. Additionally, this marketplace would include a consumer protection ratings system and consumer reviews. The consumer protection ratings system would be developed in coordination with the CFPB. Both individual products as well as service providers could be rated. If a service provider's rating fell below a certain threshold, the provider could lose access to the online marketplace.

PUBLIC OPTION AS A MODE OF REGULATION

In addition to providing the infrastructure for universal access to the payment system, a public option in household financial services would promote public-private competition, ultimately providing the government with a new mechanism for regulating the financial industry in the public's interest.

Regulating Financial Services by Directly Providing Them to Households

Direct provisioning of "plain vanilla" financial services by the federal government to households would serve as a powerful tool to set the distribution of risk in basic financial markets and enforce a minimum level of consumer protection through competition. Providing households with simple, transparent, and affordable financial services that shielded them from risk would directly set the allocation of risk for those using public services. Moreover, a public option would also indirectly regulate the terms of private services through competition. Public services would anchor the market by providing a standard template that would serve as a point of comparison for private financial services. The terms of private services would be compared with those offered through plain vanilla services, and deviation from the standard template would need to be justified to borrowers. This need to justify loan terms would put the burden of proof on the lender to convince the borrower that the additional loan terms added value for consumers, rather than shifting risk towards the consumer. Private financial services that concentrated too much risk on households would be uncompetitive with public services. Additionally, the standard template created by public products would increase transparency of private services, which would help to prevent consumer financial protection abuses based on asymmetric information or outright deception.

The argument that it is in the public interest for private intermediaries to bear the most risk, rather than households, is quite similar to the argument for making producers of consumer goods bear liability for risk(s) associated for their products. Financial intermediaries are far better suited to bear this risk and better situated to reduce total risk (Moss 2004). First, it is almost trivial to point out that financial intermediaries have a far wider variety of tools to manage risk than households do. Indeed, managing risk is a raison d'etre of a financial sector in a capitalist economy. As such, financial institutions have far more tools for managing risk, such as greater information and information processing capabilities and deeper internal and external sources of finance, including direct or indirect access to public financing provided through the Federal Reserve system.

More significantly, similar to producers of consumer goods, private intermediaries are much better positioned to monitor and reduce the total amount of risk associated with their services, and making them bear this risk gives them an incentive to do so. For example, intermediaries are much better suited to monitor the determinants of defaults across their products than households are because they have access to the loan-level data, underwriting models, and information processing capabilities needed to do so. If they find features of their services that contribute to a higher default rate, they can directly eliminate those features. Alternatively, if the features were highly desirable and added an acceptable amount of risk, private intermediaries could price this risk into the service and distribute the risk evenly across the risk pool. Financial intermediaries also have detailed information on total risk or the concentration of risk in their pool, and so they could act to reduce total risk or pockets of risk in real time (Moss 2004).

In contrast, individual households typically lack the loan-level data or information processing capabilities to monitor risk or estimate the determinants of default risk across financial services. Even if they could, any one household would also lack the power to compel a service provider to alter the terms of their services. Perhaps households could collectively exercise consumer sovereignty, but this would suffer from the classic collective action problem of free riding in the face of small-distributed interests. Similar to consumer product liability law, it would be better for private intermediaries to bear a greater degree of the risk, as they have a more robust toolkit for doing so (ibid.)

Regulating through the Management of an Online Financial Services Marketplace

Managing an online financial services marketplace would provide a powerful regulatory tool for the government, as it could limit access to the marketplace to only those firms willing to accept high consumer protection standards. Here, the government could set the allocation of risk between households and private intermediaries by setting the terms on which private intermediaries accessed this market. A key component of this program would be a consumer protection ratings system, for both servicers as well as providers, developed in coordination with the CFPB.

> ***Managing an online financial services marketplace would provide a powerful regulatory tool for the government, as it could limit access to the marketplace to only those firms willing to accept high consumer protection standards.***

Standardized ratings systems have been successfully used in numerous contexts to eliminate consumer protection abuses based on informational asymmetries or outright fraud. For example, grain is often described in economics textbooks as the canonical example of a uniform product. In actuality, however, grain quality is highly heterogeneous across numerous dimensions, such as type of grain, weight per bushel, presence of other seeds, amount of foreign material, and many other measures. The development of a rating system by the U.S. Department of Agriculture allowed wheat to be easily traded because the buyer knew exactly what they were getting (Akerlof and Shiller 2015). Developing a standardized template for rating consumer protection could prevent consumer protection abuses by increasing transparency of services, shining a light on hidden contractual clauses, and creating a standard pricing system to eliminate hidden fees and allow for easier adoption of best practices.[10]

The consumer protection ratings system would help to shield households from risk by simply prohibiting financial innovations that redistributed risk away from financial intermediaries and towards households. New private innovations would need to be rated before they could be listed on the public marketplace, and innovations that redistributed risk towards households would receive low ratings. If these innovations redistributed too much risk towards borrowers, their ratings would be sufficiently low that they would not be listed.

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[10] Hidden fees and transactions costs are especially onerous for first-time homebuyers. Total transactions costs can often total over half of the down payment for first-time homebuyers (Akerlof and Shiller 2015).

The online financial services marketplace would also serve as a powerful early warning system for the concentration of financial risk on households and new consumer protection violations. A key component of this would be consumer reviews of products and sellers. Consumer reviews would give consumers a voice in addressing consumer protection issues as they emerged. If enough complaints accumulated for a product or seller, then their consumer protection rating would be reviewed by the public bank and CFPB. If this review found that the complaints were warranted, then the product or sellers' rating would be downgraded. If the downgrade was sufficiently large, this product or seller would be excluded from the online marketplace.

A Complementary Solution to Current Regulatory Tools

The regulatory tools created by providing financial services to households and intermediaries through a public option would be complementary to the CFPB's current regulatory toolkit. Regulating through competition from below would overcome two constraints that stem from the fact that the CFPB's powers are limited to ensuring consumer protection only through prohibiting abusive practices, command, and control restrictions. The first restriction is that while the CFPB can use rulemakings to curtail consumer protection abuses, it cannot mandate that intermediaries provide products that embody best practices. For example, the CFPB cannot simply mandate that a private lender directly provide plain vanilla products to which more complex products can be compared. Additionally, the CFPB cannot mandate that a private lender directly provide services to those who currently lack access to financial services (Levitin 2012). A second limitation to restrictions imposed from above is that there are detection and enforcement costs in identifying abuses and prohibiting them. For example, prior to rulemaking, the CFPB must identify the abusive practice and thoroughly document it. To enforce the restriction, the CFPB must file a civil suit and engage in extensive litigation. Therefore, there is potentially a substantial lag time between when the abusive practice occurs, when it is discovered, and when the prohibition of such practices is enforced.

Regulating through the competition created by the direct provision of services would help to overcome both of these limitations. The CFPB would not need to directly compel private lenders to provide plain vanilla services, or services to the excluded, because it could directly provide them itself. Moreover, directly providing plain vanilla services would also give private intermediaries a strong incentive to provide plain vanilla services, as well. Additionally, competition from public products would create a persistent deterrent for abusive products in the market. These services would be uncompetitive with public services, reducing the need to rely on costly detection and enforcement.

Regulating from below through competition would also address limitations with the structure of regulation. For example, the ability to regulate through competition from below would prevent the regulatory arbitrage that occurred following deregulation. As intermediaries adopted similar business models following the removal of restrictions on their activities, they could change their charter to whatever regulatory institution would offer the least restrictions. The quality floor implemented through a public option prevents this because it would apply to all institutions, regardless of the type of charter, or even if they lacked a charter.

The additional capabilities provided by managing an online marketplace would also complement current regulatory capabilities by helping to prevent regulatory arbitrage. For example, consumer protection ratings used in the marketplace would apply to all institutions, regardless of which regulatory institution chartered them. Institutions would not be able to avoid this rating system by switching charters to a less stringent regulatory authority. Unregulated entities such as shadow banks would not be able to avoid this ratings system and still be listed in the public marketplace.

Conclusion

In this paper, we extend the recent literature on financial exclusion and consumer financial protection abuses by exploring how a public option for household financial services would serve as powerful method of regulating these problems. We have shown how the public option would help to ensure universal access to basic financial services, as well as prevent the concentration of risk on households or other consumer protection abuses through direct public-private competition. We have also shown that the use of public options as regulatory mechanisms has a well-pedigreed history of success, both in the U.S. and throughout the world. Indeed, it was the public options of the New Deal that supported stable mortgage finance in the postwar period.

Throughout our paper, we have argued for treating household financial services as essential infrastructure to which the federal government should ensure universal access, rather than leaving provision of these services to the market. Underlying this is an understanding that these services have an essentially public character, which requires public support. We chose to emphasize the public character of financial infrastructure because it was a hard-won lesson from the Great Depression—that has largely been forgotten. For example, a description of the reasons for financial regulation in the 1940s stated that, "The primary reasons for bank supervision lie in the fact that, by the very nature of their business, banks are quasi-public institutions; and in the further fact that, at times, some banks have failed to meet their obligations and responsibilities, with serious consequences to the public" (D'Arista 1994).

We chose to emphasize the public character of financial infrastructure because it was a hard-won lesson from the Great Depression—that has largely been forgotten.

Unfortunately, the recent Great Recession forced policymakers to relearn the consequences of allowing essential financial infrastructure to decay. However, while policymakers are confronted with the task of rebuilding this infrastructure to withstand the old problems of financial exclusion and consumer protection abuses, they are fortunate to be able to learn from the lessons of the past. One of the most important lessons is the power that the public option holds as a mode of regulation. It is our hope that this paper aids with relearning this lesson and applying it to create a robust financial infrastructure for the next generation.

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