How The Poor Got Cut out of Banking

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ABSTRACT

The United States currently has two banking systems—one for the rich, one for the poor. It wasn’t always this way. Throughout U.S. history, the government has enlisted certain banking institutions to serve the needs of the poor and offer low cost credit to enable low-income Americans to escape poverty. Credit unions, savings and loans and Morris Banks are three prominent examples of government-supported institutions with a specific focus of helping the poor. Unfortunately, these institutions are no longer fulfilling their missions and high-cost, usurious, and sometimes predatory check-cashers and payday lenders have quickly filled the void. These fringe banks do not provide the poor with useful credit and further bury them in debt.

This article tracks the neglected history of government sponsored institutions designed to offer credit to the poor and explains how each abandoned its initial purpose. In doing so, the article highlights the shifts in modern banking that rapidly increased competition among banks and caused homogenization in form. Alternative banking institutions could not survive deregulation and were forced to assimilate and operate like mainstream banks with heightened profits as their sole objective. The poor were the victims.

This article proposes to re-establish government-sponsored banks to serve the poor. Options include redesigning existing government measures as well as a novel proposal to use the existing postal service branches to offer low-cost, short-term credit to the poor. Such proposals have strong historic roots and could allow millions of low-income Americans the opportunity to escape poverty.

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INTRODUCTION

Poverty in the United States is rising while economic mobility is declining. A complex variety of factors and circumstances cause poverty, making its alleviation a difficult puzzle for even the most committed policymakers. Pernicious poverty implicates every facet of society and the legal structure, but most obviously, poverty is about money—the lack of it, the inability to make it grow, and the inability to borrow it. The poor have unique financial needs and challenges and cannot be offered banking services as though they are simply rich people with less money. And it is on this front that the U.S. banking system is failing the poor.

A recent study found that over half the population of the United States would not be able to access $2,000 in thirty days to respond to an emergency.¹ Further, approximately 88 million people in the U.S., 38% of the population, are “unbanked,” meaning they have no formal relationship with a bank, or “underbanked,” meaning they do not have access to incremental credit.² Thus, they must rely on payday lenders or check cashers or other fringe banking institutions to meet their short-term credit needs. These lenders are often usurious, sometimes predatory, and almost always much worse for the working poor than the services offered by traditional banks to their customers.

Most scholars and policy-makers agree that fringe banks have high costs for the poor and further dislocate them from traditional banking institutions by preventing them from building up a credit history.³ Many have advocated regulating such institutions or even banning them.⁴ Proposals include technical regulatory changes aimed at usurious rates, increased disclosure, and other consumer protection measures.⁵ Rather than joining the

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³ See, e.g., JOHN CASKEY, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWNSHOPS, AND THE POOR (1994); Michael Barr, Banking the Poor, 21 YALE J. ON REG. 121 (2004) [hereinafter Barr, Banking the Poor].
⁵ See, e.g., Barr, Banking the Poor, supra note __; Pearl Chin, Payday Loans: The Case for Federal Regulation, 2004 U. ILL. L. REV. (2004); Benjamin D. Faller, Payday Loan Solutions: Slaying the Hydra (and Keeping It Dead), 59 CASE W. RES. L. REV. 125 (2008); Brian M. McCall, Unprofitable
chorus of scholars looking to improve payday lending and check cashing institutions, this article takes a more fundamental approach. It seeks to examine the gaping hole that these services are currently filling.

For most of U.S. history the credit needs of the poor were met by banking institutions specifically created and designed to appeal to them. Credit unions were a populist innovation designed to give the poor control, choice and ownership over their money, with the protection of federal insurance.\(^6\) The Savings and Loan (S&L) was created to enable middle and working class homeownership.\(^7\) Each of these institutions was designed as a cooperative: their defining features were common ownership and forbearance of profit.\(^8\) In contrast, the little-known Morris Bank was a for-profit banking venture aimed at the “democratization of credit,” which was envisioned as giving the poor access to small loans.\(^9\) Credit unions, S&Ls and Morris Banks operated outside of mainstream banking and used innovative structures and products to meet the unique needs of the poor. Each of these banks was born of necessity, eventually supported by the government, and expanded across the country. Each then drifted from its initial mission.

The drift resulted in part from deregulation. Before the 1980s, the federal and state governments tightly controlled banking by limiting the activities banks could perform.\(^10\) Due to changes in both capital markets and political ideologies, banks began to expand their reach and activities.\(^11\) The banking sector quickly grew in size and scope and lobbied successfully for decreased governmental regulation.\(^12\) Credit unions, S&L and Morris Banks were caught up in the deregulatory atmosphere of the 1980s and started to compete with mainstream banks for business and customers.\(^13\) This led to a convergent evolution in banking. Banking form homogenized leaving little

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\(^6\) See infra Part IV.A and accompanying notes.

\(^7\) See infra Part IV.B and accompanying notes.

\(^8\) See infra Parts IV.A & IV.B.

\(^9\) JAMES GRANT, MONEY OF THE MIND 76 (1992); see also infra Part IV.C.


\(^11\) Id. at 15-17


room for variation in institutional or regulatory design. The movement away from government interference and toward free market dominance culminated in the recent banking crisis. Faced with global recession, few scholars continue to espouse unrestrained free markets when it comes to regulating banks. However, none have focused on some of the most important victims of the initial shift—the banks of the poor.

The market’s answer to banking for the poor—fringe banking—is unacceptable. What we have today are 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 needs of the poor. What is missing from the American banking landscape for the first time in generations 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 must 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 history.

Since the inception of bank chartering in the United States until the last few decades, there existed an understanding that banks were “affected with a public interest.” Chartered by the state and supported by the public fisc, they were embodied with a “public nature.” It is this vision of banks as public trustees that has disappeared. Yet, banks are still in many ways state-sponsored institutions and in the wake of the financial crisis, many were technically “nationalized.” Banks still rely heavily on public subsidies and public bailouts, yet they have been relieved of their obligation to meet certain public needs. To be clear, mainstream banks should not be forced to meet the needs of the poor. Nor should the needs of the poor be outsourced to them.

Turning to banking history for insight, this article proposes a few options to meet the needs of the poor that go beyond merely regulating the current private institutions that are “serving” the poor. First, the article explores a few existing programs that can be re-designed in order to more adequately serve the needs of the poor. The article will examine the shortcomings of legislative efforts and self-help movements by the poor and

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15 Schaake v. Dolley, 118 P. 80 (Kansas 1911).
16 Id.
illustrate how these efforts can be strengthened. The second proposal calls on the federal government to engage in a large-scale effort to provide low-cost credit to the poor using the postal service branch network. The postal service has been enlisted before in efforts to serve the poor and it provides efficiencies due to economies of scale.\footnote{See infra Part IV.C.} The postal service would offer check-cashing and payday lending services to the poor at an interest rate that accurately reflects the risk of credit.

Part I of this Article describes the current landscape of low-income banking, specifically why the poor need access to banks and the damaging alternatives that have taken the place of mainstream institutions in poor communities. Part II outlines the creation, development, and eventual demise of three institutions aimed at meeting the needs of the poor: The credit union, the savings and loan, and the Morris Bank. Part III then examines why these institutions have changed and why no institutions have replaced them. The article illuminates the larger political and social shifts as well as the resulting regulatory changes that have led banks away from serving communities and toward seeking higher profits. Part IV reviews the deficiencies in ongoing efforts to enlist mainstream banks in serving the poor as well legislation intended to remedy the problems of access without an attempt to escape the modern market model of banking. This part then makes some specific recommendations that are rooted outside the mainstream banking framework and that allow alternative banking institutions to properly meet the needs of the poor.

I. BANKING FOR THE POOR: NEEDS AND BARRIERS

Policymakers have always recognized that access to financial services and credit is a significant step toward individual economic advancement.\footnote{See Barr, Banking the Poor, supra note __, at 134-41.} Credit gives low-income workers and the poor the ability to absorb financial reversals, the means to start or expand a small business, and the capacity to build a financial safety cushion to withstand individual economic shocks.\footnote{“Access to credit assures access to basic necessities for debtors who, because of un- or under-employment, lack an adequate income to pay for essentials like food, shelter, and medicine.” Regina Austin, Of Predatory Lending and the Democratization of Credit: Preserving the Social Safety Net of Informality in Small-Loan Transactions, 53 Am. U. L. Rev. 1217, 1227 (2004).} Several studies have demonstrated that when poor communities are provided access to credit and other banking services, they thrive economically.\footnote{See Barr, Banking the Poor, supra note __, at 123; see also ASLI DEMIRGÜÇ-KUNT ET AL., FINANCE FOR ALL: POLICIES AND PITFALLS IN EXPANDING ACCESS 99-139 (2008) (concluding that “the bulk of the evidence suggests financial development and improved}
show that small-scale credit leads to increased income and savings among borrowers. It is also true that barriers to credit significantly hamper the economic development of poor communities and individuals.

Access to credit is an important means by which the poor can overcome poverty. The poor need access to long-term credit such as student loans and business loans, as well as short-term credit for daily and emergency needs that are not met by mainstream loan products. But being “banked” is not just about getting a loan; it is also about having a secure place to invest, building a credit history, and being able to avoid expensive fringe financial services.

A. The Costs of Fringe Banking on the Poor

The rise of fringe banking correlates directly with the decline of accessibility to low-cost credit from government-sponsored banks, such as the credit union and savings and loan. Scholars note that since “low-to-moderate income customers have lost access to banks and credit unions since the late seventies, [they] have naturally moved to [fringe lenders] for financial needs.” Fringe banking has grown exponentially since the 1980s. “There are more pawnshops today, both in absolute numbers and on a per capita basis, than at any time in United States history.” Prior to the mid-1970s, check-cashing institutions existed in only a few urban areas, but throughout the 1980s, these

access to finance is likely not only to accelerate economic growth but also to reduce income inequality and poverty.”; J. Wyatt Kendall, Microfinance in Rural China: Government Initiatives to encourage Participation by Foreign and Domestic Financial Institutions, 12 N.C. BANKING INST. 375, 378 (2008) (“Researchers have demonstrated that there is a strong, positive correlation between an individual’s access to traditional banking services and an individual’s well being.”).


23 See Kendall, supra note __, at 375 (“[P]eople with access to banking services live above the poverty line, whereas those without access to banking services live below the poverty line.”).

24 “Access to credit” is too broad a statement to be empirically measurable. The World Bank and other economists have studied this question without conclusive results as to what type of access is desirable among the poor. MICHAEL S. BARR ET AL., BUILDING INCLUSIVE FINANCIAL SYSTEMS: A FRAMEWORK FOR FINANCIAL ACCESS 14-30 (2007). This Article will not delve into this nuanced discussion, but rather, will start with the assumption that the poor have less access to credit than others and that the credit they are given is not as “good” as the types of financial products given to the non-poor. These assumptions are supported by numerous studies of credit for the poor.

25 CASKEY, supra note __, at 6.

26 Id. at 21.

27 Id. at 1.

28 Id.
institutions rapidly expanded throughout the country.\textsuperscript{29} “Virtually nonexistent in this country 20 years ago, [this sector] has grown into a $100 billion business. Since the mid-1990s, the number of payday lenders nationwide has grown over 10 percent annually.”\textsuperscript{30}

The fringe banks moved into neighborhoods vacated by banks, but in turn, the prevalence and market dominance of predatory lenders drove remaining mainstream banks out of many poor communities.\textsuperscript{31} This trend has only accelerated in recent years as banks have increasingly closed branches in poor neighborhoods in order to maintain profitability.

“Fringe banking” operations such as loan sharks, pawn shops, payday lenders, and check-cashing stores, operate at high costs to the poor. Scholars repeatedly point out the danger of having the poor serviced by unregulated lenders and have proposed specific regulations to curtail the most egregious behaviors of some of these lenders.\textsuperscript{32} There are three concerns with these alternative financial services: first, the costs of these services “reduce take-home pay,” second, low-income households face barriers to saving without formal bank accounts, and third, without a formal relationship with a financial institution it is difficult to establish a credit history.\textsuperscript{33}

Studies show that many low-income families carry a startling debt-load to pay-day loan providers, often taking out loans from one fringe lender to pay off another.\textsuperscript{34} Once these customers enter the payday loan industry, it becomes a trap from which they cannot escape. The typical check-cashing outlet charges between 1.5\% and 3.3\% of a check’s face value.\textsuperscript{35} For a typical client—who earns approximately $18,000 per year—this amounts to nearly $500 annually.\textsuperscript{36} For pay day borrowers, total annual fees amount to nearly $600 with a typical

\textsuperscript{29} Id. at 2.
\textsuperscript{30} Joe Mahon, \textit{Tracking “Fringe Banking”: The Location of Alternative Financial Services in the District Shows that They Serve a Distinct Need}, FED GAZETTE 18 (Sept. 2008), available at http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4030.
\textsuperscript{32} See, e.g., CASKEY, supra note __; Barr, \textit{Banking the Poor}, supra note __.
\textsuperscript{33} Michael S. Barr, \textit{An Inclusive, Progressive National Savings and Financial Services Policy}, 1 HARV. L. & POLY REV. 164, 164 (2007) [hereinafter Barr, \textit{Financial Services Policy}].
\textsuperscript{34} See Chin, supra note __, at 729.
\textsuperscript{35} Barr, \textit{Banking the Poor}, supra note __, at 146-47.
\textsuperscript{36} Id. at 148; see also CHRISTOPHER L. PETERSON, TAMING THE SHARKS: TOWARDS A CURE FOR THE HIGH-COST CREDIT MARKET 12 (2004). A government study indicates “the average customer is usually a woman in her middle thirties earning just over $24,000 a year. She usually rents her home and once she becomes a customer of a short-term loan company she usually remains a customer for at least six months.”
client taking out approximately 11 two-week loans per year, at an average loan amount of $300.\textsuperscript{37} The average interest rate charged is usually 500\%, well above both state and federal usury limits. Unfortunately such limits are easily evaded through loopholes that enable “charter lending” whereby a payday lender forms a relationship with a federal bank and the payday lender “solicits, manages, and issues each loan, but ostensibly uses the federal bank’s funds in exchange for a per-loan fee.”\textsuperscript{38} The alternative financial service industry’s success is due to their ability to take advantage of the federally sponsored banking system and it has come at the expense of the poor, many of whom, ironically, do not have access to these same government subsidies and protections.

B. Barriers to Banking for the Poor

There are a variety of barriers that keep mainstream banks from serving the poor, the first of which is profitability. The poor may need banks, but the reverse is certainly not true. Most agree that “providing [financial] services to the poor is fundamentally unprofitable.”\textsuperscript{39} Banks have struggled to offer small loans to the poor both due to the poor’s higher credit risk as well as the narrow margins of profitability on small loans. Banks incur approximately the same costs originating a loan regardless of the principal amount, but generate much greater returns from large loans.\textsuperscript{40} Moreover, mainstream commercial banks have an obligation to their shareholders to maximize profits and “should not be required to extend credit if sound judgment suggests undue risks.”\textsuperscript{41} Thus banks look up the financial ladder to attract the funds from corporations, pension funds and high-net-worth individuals and unregulated fringe bankers meet the needs of the poor. This tendency has created two banking systems in America: a government-

\textsuperscript{37} Barr, Banking the Poor, supra note __, at 157.

\textsuperscript{38} Peter, supra __, at 14 n.28; see also Austin, supra note __, at 1241 (describing bank and payday lender partnerships as specifically designed to take advantage of loopholes in banking law in part because banks are eager to have fee income). This trend, including “Rent-a-Charter” arrangements, has apparently survived the recent banking crisis, as banks and payday lenders continue to partner in payday lending to split the fees from such loans. See Christopher Konneker, Comment, How the Poor Are Getting Poorer: The Proliferation of Payday Loans in Texas via State Charter Renting, 14 Scholar 489, 509-10 (2011)


\textsuperscript{40} Solomon, supra note __, at 192.

\textsuperscript{41} Ivan Light & Michelle Pham, Beyond Creditworthy: Microcredit and Informal Credit in the United States, 3 J. Dev. Entrepreneurship 35, 37 (1998).
subsidized mainstream banking system for the rich and an unregulated alternative banking system for the poor.

C. Discrimination and Redlining

Discrimination and redlining also limit the poor’s access to banks. Compounding the problems with profitability in serving the poor, studies show that there is rampant discrimination in banking where loans are denied to credit-worthy individuals simply due to their race. As many of the unbanked and under-banked are also people of color, this has exacerbated their problems of access. Others studies show that minorities are also offered worse financial products than whites. Moreover, banks often engage in red-lining, which refers to the practice of drawing a red line through certain neighborhoods and refusing to lend there due to historic poverty, racism, or lack of adequate collateral.

Some policymakers and scholars have given up trying to force banks to meet the needs of the poor, claiming that cost considerations prevent delivery of services in some markets. Frustrated, some claim that “banks’ potential for service improvement [to the poor] is modest even were they run by God’s angels.” Banks don’t have to be run by “God’s angels” to properly serve the poor—but they must be run in a different way than most banks are today. Banking history shows a variety of examples of banks that successfully met the needs of the poor while operating outside the mainstream model.

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42 See Michele L. Johnson, Your Loan Is Denied, But What About Your Lending Discrimination Suit?: Latimore v. Citibank Federal Savings Bank, 151 F.3d 712 (7th Cir. 1998), 68 U. CIN. L. REV. 185, 192-94 (1999); see also Light & Pham, supra note __, at 38 (“Results [from a Boston Federal Reserve Bank study] showed that blacks and Hispanics were 56% more likely than non-minorities to be denied a mortgage loan net of creditworthiness.”); Shahien Nasiripour, Wells Fargo Target of Justice Department Probe; Agency Alleges Discriminatory Lending, Huffington Post (July 26, 2011, 10:00 PM, updated Sept. 25, 2011, 6:12 AM), http://www.huffingtonpost.com/2011/07/26/wells-fargo-justice-department-probe_n_910425.html. See generally, Helen F. Ladd, Evidence on Discrimination in Mortgage Lending, 12 J. OF ECON. PERSP. 41 (1998) (concluding that lending data made available through various legislation shows clear discrimination in mortgage lending against minorities); Natasha Lennard, Did Wells Fargo Prey on Black Borrowers, SALON.COM (July 27, 2011, 11:28 AM).

43 Id.

44 Lan Cao, Looking at Communities and Markets, 74 NOTRE DAME L. REV. 841, 851-52 (1999).

45 See, e.g., Malmquist et al., supra note __, at 181-82; Posner, supra note __.


47 Id. at 39.
D. The Façade of Informality

Even when banks remain geographically available, they are often out of reach. Due to various regulatory measures, mainstream banks require extensive documentation such as utility bills, a driver’s license, and a social security number or alien documentation number, in order to open an account.\(^48\) Providing an array of documentation such as these can be a significant barrier to banking for many, in contrast to the ease by which they can access funds from fringe banks. In addition, many of the American poor, who are immigrants or uneducated, often do not speak English, may be illiterate, or have significant information barriers to traditional banking structures. There are also intangible barriers of class and culture. When the poor have been asked about using fringe banks rather than mainstream banks, many claim that they feel more “comfortable” with these institutions.\(^49\)

Thus, not only has mainstream banking abandoned poor areas by shutting down branches, but also by failing to speak the financial language of the poor. Payday lending businesses operate behind a façade of informality. These lenders operate in cash, at all hours, on a short-term basis, in the direct vicinity of their customers, and usually in their language.\(^50\) This business model seems to be in direct contrast to banks with their rigid hours, requirements, fees, and procedures. Many of the poor feel “snubbed” by mainstream financial institutions and are “pride-conscious” more than “price-conscious” and are therefore “susceptible to the appeal of the secondary sector’s ‘merchandising of respect.’”\(^51\)

Despite the informal facade, fringe banks are strong corporations whose rigid practices come into play as soon as debts become due. These

\(^48\) See Barr, supra note 3, at 184.

\(^49\) Barr, Banking the Poor, supra note __, at 180 n.282; Arthur B. Kennickell et al., Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances, 86 FED. RES. BULL. 1, 9-11 (2000) (“About 18% of unbanked respondents to surveys reported that they were not ‘comfortable’ dealing with banks.”).

\(^50\) See Michael A. Stegman & Robert Faris, Payday Lending: A Business Model that Encourages Chronic Borrowing, 17 ECON. DEV. Q. 8, 13 (2003). Stegman and Faris cite to “[f]ocus groups of low-income and ethnic consumers . . . [that] identified five ways in which check cashers were superior to banks: (a) easier to access for immediate cash; (b) more accessible locations; (c) better service in the form of shorter lines, more tellers, more targeted product mix in a single location, convenient operating hours, and Spanish-speaking tellers; (d) more respectful, courteous treatment of customers; and (e) greater trustworthiness.” Id.

\(^51\) Id. at 1249 n.177.
businesses resort to intimidation, harassment, and legal process in order to collect payments. By mimicking informal markets, these fringe banks have convinced their customers that they are operating in the informal realm, but their debt collection practices are nothing but formal and inflexible. As one commentator observed about a Washington, D.C. check-cashing outlet, “[t]he primitive hands-on processing and tawdry exterior of the outlets both exude welcome to poor customers and mask [the firm’s] close ties to and substantial financing from large corporations and big banks.”

E. Democratization of Credit?

The payday lending industry claims that they are serving the needs of the poor and are promoting “the democratization of credit.” However, this industry does not provide credit that is productive to the poor. The poor are often more in debt after their interactions with payday lenders than before. The industry, instead of being an aid to lift the poor out of poverty, buries them further in debt. “The true democratization of credit should foster the enhanced well-being for the least-well off borrowers.”

What the poor need are flexible, informal banks that operate in their neighborhoods and are able to communicate in both their spoken and cultural language. It is not implausible to imagine a government-supported institution that could serve the poor in the same way as fringe banks by understanding and meeting their needs. A 2008 report describing the financial conditions of the poor in New York City stated that there is a “fundamental mismatch between current financial product and service offerings and the needs of households in these communities,” which is the primary reason banks are not reaching the unbanked. The underbanked make up 38% of the U.S. population and continue to grow and their primary needs are short-term

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52 Peterson, supra note __, at 16.
55 See supra Part I.C. and accompanying notes.
56 See supra Part I.C. and accompanying notes.
57 Austin, supra note __, at 1277.
financing.  

In the past, when unique barriers to serving the poor arose, specialized banking institutions created innovative products to meet those needs. In order to meet the needs of the poor today, institutions will need to overcome the documentation, language, and cultural barriers of the poor and operate in their neighborhoods. As discussed below, the government, through the vast branching network of the US Postal Service could potentially offer the true democratization of credit. Postal branches operate in every zip code and are both familiar and accessible to the poor. The government could launch a program to offer short-term, low-cost credit options through the postal service. Indeed, “We live in a real-time economy. Banks have more than enough technological horsepower and data on consumer behavior patterns to cash paychecks with little to no risk.” The government could offer many if not all of the products that fringe banks currently offer at a lower cost.

II. WHEN THE POOR HAD BANKS

In the early days of banking, there was recognition that banks were an instrumental state entity and that they were to be used to benefit the “common people.” Thus, state and national governments employed banks to further government objectives. Many of the first state banks were chartered to meet the credit needs of farmers, planters and mechanics who lacked access to the United States National Bank.

During the industrial era, the nation’s banks expanded and resulted in an accumulation of power to those with access to bank funds and a growing discomfort in those without access. During the 19th century, as American industrialists were getting richer and the economy was expanding with the help of bank financing, a growing number of poor Americans clamored to be included in the banking sector. During the 1800s, an organization that was first called the “Knights of Reliance” and later, “the Farmers’ Alliance” was formed in Texas to oppose the concentration of banking in the East and the power of

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59 Jennifer Tescher, Underbanked and Under Banks’ Radar, AM. BANKER, Apr. 27, 2011, http://www.americanbanker.com/issues/176_81/underbanked-under-radar-1036618-1.html?pg=1 (“an FDIC study showed that the nonbank products and services used most frequently by underbanked households are money orders (81%) and check cashing (30%)”)

60 Id.


62 HOFFMANN, supra note __, at 72.

Wall Street. This populist movement advocated farming cooperatives across the country that were not beholden to eastern banks. Cooperatives were mutually owned and controlled financial institutions where poor farmers pooled their resources and supported each other’s ventures.

The Progressives embraced these alternative banks and advocated the “democratization of credit,” or the extension of credit to the working poor. In response to these political movements by the poor that intensified during the Progressive Era and during the Great Depression, credit unions and the S&L were created. The farming cooperatives provided the model for the credit union industry.

In addition to these formal institutions, there were several other banking ventures aimed at helping the poor. The Provident Loan Society, established in 1894 with $100,000 provided by the richest men in New York City was a charitable organization that aimed to “relieve distress through enlightened and liberal lending but also, through competition, to force lower margins on profit-making pawnbrokers.” By 1919, it was making more loans than any domestic savings bank with a policy “first, to make small and costly loans and, only second, to make large and profitable ones. It made loans as little as one dollar” that required minimal collateral. The fund’s humanity was in stark contrast to the pawnbrokers at the time, but due to the nature of the bank’s loans, “the truly indigent, almost by definition, were excluded, as they had nothing to pawn.”

In 1873, President Grant’s postmaster general proposed a government-sponsored savings program, modeled after one started in Britain. The idea snowballed until President Taft responded to growing populist proposals to establish a government-backed savings system for recent immigrants and the

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65 ROBERT GUTTMAN, HOW CREDIT MONEY SHAPES THE ECONOMY: THE UNITED STATES IN A GLOBAL SYSTEM 68, 76-78 (1994).
66 See HICKS, supra note __, at 138.
67 GRANT, supra note __, chapter 4.
68 Lash, supra note __, at 386-86.
69 GRANT, supra note __, at 77, 85.
70 Id. at 85.
71 Id.
72 Id. at 87.
73 Id.
poor. The Postal Savings System enabled the poor to save money with the assurance of a government guarantee. These savings accounts were created and geared to recent immigrants and the unbanked poor, and were widely 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.” The Post Office inspector, 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 on the government and will trust no other institution.”

Throughout American history, there have been various state-supported attempts to meet the banking needs of the poor. The following section outlines the history of three banking institutions that were created for the poor and their eventual abandonment of their mission. Interestingly, all of these banks changed roughly at the same time—in the 1980s. The causes of this collective change in banking will be examined at length below. These banks shared several common traits: they were born of necessity to meet the needs of the poor, they formed special charters that were different from mainstream banks and were embraced by the law, they each drifted from their founding mission to serve the poor and started to compete with other banks, and they were each deregulated in order to compete with mainstream banks. None of these banks operated at a large profit, but that was not the point of their charters. Today, all of these banks maintain profit margins rivaling mainstream banks and are marketing their products to wealthy individuals.

A. Credit unions

1. Born of Necessity

Credit unions started as a populist mechanism designed to empower
farmers against bad loans that kept them indebted to bankers. Farmers needed credit to run their businesses, but their source of credit was typically confined to traditional banks that were based in major cities like New York and Boston. As the Great Depression took its toll on farms across the country, farmers quickly became heavily indebted to these outside banks and often lost their equipment, land, and livelihood. This quickly led to a populist sentiment that resulted in farmers organizing a grassroots campaign to start credit unions. Credit unions were envisioned as a way to cut out the middle-man, or commercial banks, and give farmers access to lower-cost credit.

Thus, the proliferation of credit unions in the United States came in response to the Great Depression. Previously, banks had made their services available mostly to corporations and wealthy individuals, disregarding lower income individuals. This left this underserved group susceptible to exploitation. Loan companies would often charge up to the maximum interest rate allowed by law, while installment buying would exploit those in need of credit through "confusing rate schedules and discount schemes . . . ." Those unwilling or unable to navigate these legal alternatives to banks were forced to turn to loan sharks, who would extract “up to a thousand percent” interest rates. These high interest rates reduced purchasing power among the poorer classes, which in turn contributed to the economic malaise of the times.

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78 See Rabin, supra note __, at 1203-04.
79 See id. at 1203.
80 80 CONG. REC. 6752 (1936).
81 See Fred Galves, The Discriminatory Impact of Traditional Lending Criteria: An Economic and Moral Critique, 29 SETON HALL L. REV. 1467, 1479 n.18 (1999) (“Perhaps the most remarkable success story, however, was the credit union movement. Credit unions have been around since early in the century. They sprang from the...public spirited impulse...to facilitate the supply of consumer credit to workers, farmers, and other[s]...whose credit needs were not being adequately served by existing banking facilities.” (quoting JONATHAN R. MACEY & GEOFFREY P. MILLER, BANKING LAW AND REGULATION 28-29 (1997)); Kelly Culp, Banks v. Credit Unions: The Turf Struggle for Consumers, 53 BUS. L. 193, 194 (1997).
82 80 CONG. REC. 6753 (showing that the number of credit unions grew from 257 in 1925 to 1,017 in 1930 and to 4,000 in 1935; and credit union membership grew from 292,800 members in 1930 to 1,000,000 members in 1935).
83 History of Credit Unions, NATIONAL CREDIT UNION ADMINISTRATION (NCUA), http://www.ncua.gov/about/history/Pages/CUHistory.aspx (last visited Feb. 1, 2012)
84 80 CONG. REC. 6752; see also 78 CONG. REC. 7260 (1934) (comments of Senator Sheppard). Senator Sheppard recounted the story of a man earning $40 per week undertaking an installment purchase plan that required him to pay $52 per week.
85 80 CONG. REC. 6752; see also 78 CONG. REC. 7260 (comments of Senator Sheppard). Senator Sheppard recounted the story of “a railroad employee who borrowed $30 from a loan shark, paid in interest $1,080, and was then sued to recover the $30. He paid 3,600 percent.” Id.
86 78 CONG. REC. 7260 (comments of Senator Sheppard).
Specifically, credit unions provided a method of lending in which farmers and villagers were organized into credit groups. The borrowers would then repay the loans when they were financially able to do so. Joining a group required recommendation from one’s neighbors, and entitled one to deposit, borrow, and vote on the operation of the bank under a one-man-one-vote system. Borrowers would receive loans “for productive and provident purposes upon security that the fellow credit unionists thought adequate.” Interest paid on loans was kept low, even though it was a credit union’s sole source of income.

2. An Innovative Response

The early credit unions were able to overcome the high costs associated with lending to the poor, such as risk of delinquency, through group supervision. There was a requirement that there be a “common bond” among credit union members, which was aimed at reducing the cost of credit and the chances of delinquency because members knew each other. By design, loan repayment was limited to two years, and the maximum interest rate chargeable was 1 percent per month. The credit union’s innovative response to high-cost credit was to use personal knowledge of an applicant as a proxy for the high interest usually used to offset the risks of lending to the low-income.

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87 Id.; see also 80 CONG. REC. 6752.
88 See 80 CONG. REC. 6752.
89 Id.
90 Id.
91 Id.
92 Id.
94 See First Nat’l. Bank v. Nat’l. Credit Union Admin., 863 F.Supp. 9, 10 (D.D.C. 1994) (“The original purpose behind the common bond provision was twofold: to insure the financial stability of credit unions by providing a sense of cohesiveness among members and by enabling the members to establish a borrower’s credit worthiness at minimum cost; and to promote the growth of credit unions because it was faster and easier to form a credit union with members who already had a common bond.”); see also 78 Cong Rec. 7259 (comments of Senator Barkley), 7260 (comments of Senator Sheppard).
96 78 CONG. REC. 7259–60 (comments of Senator Barkley and Senator Sheppard); History
The common bond requirement served several important purposes. Primarily, it was a substitute for the members' lack of credit history or collateral that traditional banks required to issue loans.\(^97\) Congress intended the common bond among the members of a credit union to create “a cohesive association in which the members are known by the officers and by each other in order to ensure both that those making lending decisions would know more about applicants and that borrowers would be more reluctant to default.”\(^98\) Such a cohesive association theoretically allowed “credit unions, unlike banks, [to] ‘loan on character.’”\(^99\) The common bond made federal credit unions distinctly tailored to serve the needs of lower income individuals.

3. Embraced by the Law

These initial credit unions later served as the catalyst for the Massachusetts Credit Union Act of 1909,\(^100\) the first state credit union act, which in turn later served as the basis for the Federal Credit Union Act.\(^101\) The majority of states passed laws supporting the establishment of credit unions during the first three decades of the 20th Century.\(^102\) Congress passed the Federal Credit Union Act (FCUA) in 1934,\(^103\) stating that the Act addressed a
“great national problem,”104 and noting the “very extraordinary” and “highly successful” record of credit unions in addressing the “legitimate credit” needs of “the poorer and working classes” throughout the Great Depression.105

As originally passed, the FCUA required that credit union members elect management, with each member having one vote106 as well as the ability to purchase shares and to receive loans.107 Membership in a credit union was “limited to groups having a common bond of occupation, or association, or to groups within a well-defined neighborhood, community, or rural district.”108 While initially subject to taxation just as other banking institutions,109 concern arose that subjecting credit unions to the same taxation as commercial banks would place “a disproportionate and excessive burden on the credit unions.”110 Responding to this concern, Congress, three years after initially passing FCUA, amended the statute by extending significant tax exemptions to credit unions.111

The tax exemption was a critical government subsidy that allowed credit unions to continue to provide low-cost services. As a result of these provisions, the credit union industry grew dramatically during and after the Great Depression.112 Specifically, from 1945 to 1966 the number of credit unions grew from 8,683, holding $435 million in assets, to more than 23,000, holding in excess of $11.5 billion in assets.113 Additionally, these federally chartered credit unions were indeed serving the underserved, working class

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104 78 Cong. Rec. 7259 (comments of Senator Sheppard).
105 Id. at 7259-60 (noting that credit unions “came through the depression practically without runs or failures.”).
106 Id. § 11.
107 Id. § 7.
108 Id. § 9.
109 Id. § 18.
111 12 U.S.C. § 1768. Results from some recent studies suggest that traditional banking institutions would need to earn 40% more than a credit union to achieve the same level of retained earnings due to the tax exemption. See Donald Novajovsky, From National Credit Union Administration v. First National Bank & Trust to the Revised Federal Credit Union Act: The Debate over Membership Requirements in the Credit Industry, 44 N.Y.L. Sch. L. Rev. 221 (2000). This was the first of a series of alterations to the federal credit union structure dealing with safety and soundness. In 1970, Congress created the Credit Union Share Deposit Fund, a deposit insurance backed by the Treasury, analogous to the FDIC. See Pub. L. 91-468, § 1(2), 84 Stat. 994; 12 U.S.C. § 1783. In 1998, as part of the Credit Union Membership Access Act, Congress imposed heightened risk-based capital requirements on credit unions. See Pub. L. 105-219, Title III, § 301(a), 112 Stat. 923; 12 U.S.C. § 1790(d); 12 C.F.R.§ 702.
112 See Kroos & Blyn, supra note __, at 241.
113 See id. at 242.
families that needed credit to expand and succeed.\footnote{William R. Emmons & Frank A. Schmid, \textit{Credit Unions and the Common Bond}, REV. (Fed. Res. Bank of St. Louis), Sept./Oct. 1999, at 43 ("Historically, members of credit unions were drawn from groups that were underserved by traditional private financial institutions; these consumers tended to have below-average incomes or were otherwise not sought out by banks.").}

4. Credit Unions Drift from their Initial Mission

Credit unions slowly began to shift from being a resource for poor Americans to competing with other banks for the business of the middle-class. Credit unions were caught up in the broader changes in banking and faced internal as well as external pressure to compete with other banks and seek higher profits. Credit unions started losing customers to unregulated entities due to their regulatory burdens, such as the common bond requirement and the interest rate limitations—the very things that enabled them to serve the poor. These forces created pressure on the credit union industry to seek deregulation and offer more attractive interest rates to their customers who had a growing number of investment options.\footnote{HOFFMAN, supra note __, at 204 ("[Americans'] savings—not worth banks' bother in 1930—became the object of vigorous competition. . . ").}

In 1970, the industry amended the FCUA and sought to completely overhaul its charter and adopt less restrictive requirements.\footnote{Id.} Thus credit unions started to focus on attracting more customers and expanding the industry in order to stay viable among the different banking alternatives. The process of expansion and deregulation led to a change of mission. Credit unions were no longer about poverty alleviation; they were now a desirable alternative for middle-class investment.

5. Deregulation

The mantra of banking regulation in the 1970s was increased competition\footnote{Clifford L. Fry & Donald R. House, \textit{Economic Issues in the Defense of Directors and Officers of Financial Institutions}, 110 BANKING L. J. 542 (1993).} and credit unions wanted to join in.\footnote{\textit{Should Credit Unions be Taxed?}, CRS 97-548 E, 2005 WL 5518478, *1 (C.R.S.).} They started offering market-oriented products to attract and keep customers.\footnote{See id. at *5.} However, their ability to compete was hampered by regulatory burdens, such as the common bond requirement, that kept them from freely courting customers. Eventually, the industry sought to relax the common bond requirement, their defining
characteristic, to include multiple groups of people.120

As credit unions shifted their focus to compete with banks for the funds of the middle class, a debate ensued over the common bond requirement and the requirement came to represent the competitive advantage of banks vis a vis credit unions. As the economic recession of the late 1970s and early 1980s worsened, the National Credit Union Association (NCUA) undertook a reexamination of the common bond requirement. In an effort to help credit unions compete with banks, the NCUA issued an interpretive statement stating that credit union memberships could include “multiple occupational groups” as long as each group had a common bond.121 This dilution of the common bond requirement naturally led to increased credit union size, services, and competitive advantage.122

The Supreme Court found, however, that the industry could not change its defining trait unilaterally. The Court struck down this broad interpretation of the common bond under a Chevron analysis in National Credit Union Administration v. First National Bank and Trust Co in 1991.123 In swift response, the NCUA and the credit union industry began lobbying Congress for an amendment to the FCUA allowing for diversification. The NCUA’s lobbying efforts focused on the preservation of “the freedom of financial choice for America.”124 The freedom to choose credit unions over traditional banks gained some traction in Congress partly due to the fact that most of their members were now in the middle class and credit unions had turned into a formidable lobby.125

120 The NCUA issued Interpretive Ruling and Policy Statement 82-1, 47 F.R. 16775-01 (April 20, 1982), shortly followed by IRPS 82-3, 47 F.R. 26808-01 (June 22, 1982), which together expanded the common bond requirement.

121 IRPS 82-1 Membership in Federal Credit Unions, 47 Fed. Reg. 16775 (Apr. 20, 1982).

122 Immediately after this expansive interpretation, the membership in credit unions increased by 30% from 1982 until 1998. Cassity, supra note __, n.1; see also Brief for Petitioner at 12 First Nat’l Bank (Nos. 96-843, 96-847). The number of credit unions grew fourfold from 1982 until the mid-1990s and combined to control nearly $330 billion in funds from 70 million members. See Dean Foust, Clipping the Wings of Credit Unions, BUS. Wk. Aug. 26, 1996, at 56. This growth has been primarily attributed to attracting customer from outside the typical common bond requirement. For example, nearly 2/3 of all the members in the AT&T Family Federal Credit Union do not work for AT&T and are considered outside of the company. Id.


124 D’Amours Testimony, supra note __, at *7.

125 Wendy Cassity, The Case for A Credit Union Community Reinvestment Act, 100 Colum. L. Rev. 331, 333, 344 (2000) (“Even before the decision was announced . . . it was almost inevitable that . . . Congress would amend the FCUA . . . . [T]he typical credit union member--educated, middle-class, mortgage-owning--is also the average voter.”); see also Hearings Before the House Comm. on Banking and Financial Services, 105th Cong. (1998) (comments of Rep.
Six months after the Supreme Court’s decision in National Credit Union Administration,\textsuperscript{126} Congress passed the Credit Union Membership Access Act (CUMAA)\textsuperscript{127} with near unanimous support to “ratify the longstanding policy of the [NCUA] with regard to the field of membership [in] Federal credit unions [by] specifically authoriz[ing] multiple common bond federal credit unions.”\textsuperscript{128} CUMAA was considered necessary to “ensur[e] that customers continue[d] to have a broad array of choices in financial services.”\textsuperscript{129} One of the Act’s most significant features was the exemption of credit unions from the CRA, an Act aimed at providing banking access to low income individuals.\textsuperscript{130} The exemption was a direct result of credit union lobbying.

Because of the seemingly rushed nature of the CUMAA,\textsuperscript{131} critics immediately noticed inconsistencies in the Act. Specifically, although Congress imposed numeric membership requirements that sought to limit the growth of multiple common-bond credit unions, the limits were easily subverted and led to an increase, not a decrease, in credit union membership.\textsuperscript{132} Moreover, Congress did not answer the glaring contradiction raised initially by the court of appeals regarding an expansive, multiple common bond interpretation, namely how unrelated members and groups can adequately determine and evaluate the credit worthiness of the additional members.\textsuperscript{133} Additionally, the

\textsuperscript{126}See Eileen Canning & R. Christian Bruce, House Passes Credit Union Bill, BNA BANKING DAILY, Aug. 10, 1998, at 245.


\textsuperscript{129}See Alex D. McElroy, Clinton Signs Credit Union Bill, BNA BANKING DAILY, Aug. 11, 1998, at d2 (quoting President Clinton); see also Credit Union Membership Access Act, Pub. L. No. 105-219, 112 Stat. 913, 913 (1998). Representative Veto also noted that “[b]y ... allowing multiple common-bond credit unions, we are revamping and facilitating the federal credit union law and empowering credit unions to adapt to the 1990’s market place.” 144 CONG. REC. H7051 (daily ed. Aug. 4, 1998).


\textsuperscript{131}See Cassity, supra note __, at 345 n.91.

\textsuperscript{132}Donald Novajovsky, From National Credit Union Administration v. First National Bank & Trust to the Revised Federal Credit Union Act: The Debate over Membership Requirements in the Credit Union Industry, 44 N.Y.L. SCH. L. REV. 221, 243 (2000) (noting that the current statute allows “fifty 3,000 member groups [to] come together . . . [and] the net growth to the institution is 150,000 members” but the statute does not allow “three 50,000 member groups” for a net growth of 150,000 and since there are more smaller groups than larger groups it is likely that this will increase the membership in credit unions).

Act did nothing to assuage the banking industry’s fears that credit unions were acting essentially as banks without having to pay taxes or comport with the requirements of the CRA.

Today, credit unions are much like mainstream banks. The American Banking Association (ABA) has continually argued that credit unions are not fulfilling their mission to serve the underserved. Buttressing the ABA’s claim is a GAO report, which concluded that credit unions are more likely to serve middle- and upper-income people than lower-income people. Indeed, credit union expansion allowed them to compete with banks while enjoying advantageous tax and other regulatory and statutory exemptions, which taken together created an uneven playing field. Notably, some even claim that credit unions “come in and cherry-pick the most profitable [banking] business and then give nothing back to the community,” a practice far from the original objectives of the Depression-era cooperatives.

6. Community Development Credit Unions

Despite the credit union industry’s general movement away from its original objectives, there still exist credit unions specifically designed to service low- and moderate-income groups and communities. One such organization, the National Federation of Community Development Credit Unions, was organized in the 1970s “to strengthen the credit unions that serve low-income, urban and rural communities.” Credit unions with a focus on the poor call themselves “Community Development Credit unions.” However, many of these credit unions have struggled to survive.

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134 U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-07-29, CREDIT UNIONS: GREATER TRANSPARENCY NEEDED ON WHO CREDIT UNIONS SERVE AND ON SENIOR EXECUTIVE COMPENSATION ARRANGEMENTS 8 (Nov. 2006) [hereinafter GAO, CREDIT UNIONS]. According to a 1996 study done by Credit union National Association, Inc. (CUNA), credit union members had an average household income of $43,480, whereas nonmembers had an average income of $31,660—a difference of thirty-seven percent. Kelly Culp, Bank v. Credit unions: The Turf Struggle For Consumers, 53 BUS. LAW. 193, (1997-1998). And according to the American Banking Association (ABA), “credit union members have more years of education and are more likely to be employed full-time.” Id.

135 See Foust, supra note ___ (quoting Joe G. Howard, senior vice-president at First National Bank & Trust Co. in Asheboro, North Carolina).

136 See id.


138 See NCUA Letter to Credit Unions: Supervising Low Income Credit Unions and Community Development Credit Unions, Letter No. 10-CU-01 (January 2010) [hereinafter NCUA Letter]. Some estimates place the CDCU failure rate during the 1990s near fifty percent. Charles D. Tansey, Community Development Credit Unions: An Emerging Player in Low Income Communities (Sept.
Despite their struggles to remain viable, some of these credit unions have proved at least somewhat successful in fulfilling their missions. One study of New York City’s Lower East Side People’s FCU showed that the vast majority of the credit union’s borrowers were low-income minorities with little or no credit, and no relationship with mainstream financial institutions. Moreover, loans were small ($1,700) on average and for shorter terms, thus tailored specifically to meet the needs of the individuals the credit union served. CDCU’s demonstrate that it is possible for credit unions to fulfill the mission that they were initially equipped to serve.

B. Savings and Loans

The S&L framework was built for the public purpose of increasing home ownership and savings among the poor. President Hoover believed that home ownership was intrinsically good for individuals and for society and pushed for the creation of a banking institution that could help the poor overcome the barriers to homeownership. Originating in the U.S. prior to

2001), http://www.brookings.edu/articles/2001/09metropolitanpolicy_tansey.aspx. Statutory and regulatory efforts have been made to assist these credit unions in fulfilling their mission. See Lehn Benjamin et al., Community Development Financial Institutions: Current Issues and Future Prospects, 26 J. URBAN AFFAIRS 177, 178 (2004).

139 Id. Another study of Vermont’s Opportunity Credit Union showed that borrowers with little or no credit history were 30% less likely to receive auto loans from traditional banks as similarly situated individuals with some credit history. Jessica Holmes et al., Does Relationship Lending Still Matter in the Consumer Banking Sector? Evidence from the Automobile Loan Market, 88 SOC. SCI. Q. 585, 595 (2005). However, when seeking an auto loan from a CDCU, such borrowers suffered no significant disadvantage. Id. This, in large part, is due to the CDCU’s reliance on relationship lending. Id. This is significant because, as the authors explain, several studies show that relationship lending “can lower the cost of financial capital and lessen credit rationing in the markets for small business loans and consumer loans.” Id. at 585.

140 RUBIN, supra note __, at 174 (summarizing other studies with similar findings).

141 HOFFMANN, supra note __, at 141.


"With ownership comes stability, the welding together of family ties, and better attention to the rearing of children. With ownership comes increased interest in the promotion of public agencies, such as church and school, which have for their purpose a desired development of the moral and mental make-up of the citizenry of the country. With ownership of one’s home comes recognition of the individual's
the Civil War, Building and Loan associations (B&L) were set up to help “independent workingmen get suitable loans.” 143 The S&L framework combined the B&L and Savings Banks, which were created in the 19th century to facilitate saving by the poor.144 The S&Ls were labeled “the workingman’s way to wealth” and lauded the virtues of “cooperation and emancipation from landlords.”145

1. Born of Necessity

The need for these alternative sources of credit arose as a result of the collapse of the banking system in the South following the Civil War and the lack of banking services in the still-undeveloped West.146 The only functioning banks available were in the Northeast and Midwest.147 This lack of credit forced farmers in the South to turn to tenant farming, “borrowing from their landlord against next year’s crop at exorbitant prices,” while farmers on the Great Plains were relegated to subsistence farming.148 Communities in these credit-starved areas addressed these needs by creating institutions in which they pooled their money, from which those in need could receive loans to buy land, while those who had money could receive some return on their savings.149

2. An Innovative Response

Much like credit unions, S&Ls were created as mutual savings banks.150 The model of the industry was “neighbors helping neighbors.” The first S&Ls were thus mutually owned,151 not intended to make profits, but to achieve the

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143 Lloyd Rodwin, *Studies in Middle Income Housing*, 30 SOC. FORCES 293 (1952); see also MASON, supra note __, at 12.


145 Rodwin, supra note __.


147 Id.

148 Id.

149 Id.


151 HOFFMANN, supra note __, at 155; MASON, supra note __, at 21.
The public purpose of building homes for their members. These were distinctively not market entities—they were self-help institutions for the poor made possible by government subsidies and regulation. Members also participated heavily in governance much like in credit unions. S&L members elected the institution’s officers, who frequently were community leaders. This pooling and lending of resources enabled home ownership for low income people who were not given access to customary bank loans. Soon, S&Ls were able to get bank loans to assist them in making larger loans to their members.

Savings and loans created innovative products to meet their members’ unique needs. The S&L was initially responsible for creating loans that were accessible to average Americans. Their loans featured long-term amortization and high loan to value ratios (65 to 75%). These loans are familiar today, but it was the S&L that first created them. Before the S&L, banks only provided home financing for 40 to 60% loan to value ratios with a term of one, three or five years. Most people needed to get a second mortgage—through an unregulated lender with usurious rates—in order to finance their home. Mainstream home financing was not within reach of most Americans and there were no loans on older homes or low-value homes. S&Ls achieved great success in providing low and moderate income Americans access to home ownership.

3. Embraced by the Law

Savings and loans gained popularity because they met a growing need and desire of Americans. In 1930, there were over 12,000 S&Ls with more

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153 MASON, supra note __, at 22.
154 Id. at 21.
155 Taxation of National Banks, 77 BANKING L. J. 591, 591 (1960); see also Rodwin, supra note __, at 293.
156 See MASON, supra note __, at 78.
157 Id. at 91, 162; cf. Allen F. Jung, Terms on Conventional Mortgage Loans on Existing Houses, 17 J. FIN. 432, 435 (1962) (study showing that 26 of 31 surveyed S&Ls routinely offered mortgage loans with LTVs of 60% or higher).
158 See MASON, supra note __, at 16, 91; cf. Jung, supra note __, at 439–42.
159 MASON, supra note __, at 16; How A Good Idea Went Wrong, supra note __, at 645.
161 See id. at 67.
than 12 million members and assets of more than $8 billion. During the Depression, S&Ls were susceptible to runs and in danger of being shut down. Banks called in the loans to S&Ls while their customers demanded their deposits. Such is George Bailey’s dilemma in the classic “It’s a Wonderful Life.” Despite their struggles, many S&Ls survived the Depression intact because they did not hold demand deposits and were not obligated to pay their depositors right away. In 1932, Congress, with President Hoover’s backing, passed the Federal Home Loan Bank Act with the long term goal of strengthening the S&Ls to provide home mortgages and to increase home ownership.

After defeating President Hoover, President Roosevelt continued the vision for the S&L and enacted several pieces of legislation intended to help homeowners. The Home Owners Loan Act provided a federal charter to S&Ls and imposed federal control over them. S&L members initially resisted because they wanted to preserve the “local” nature of the S&L and asked that their mission be written into the charter—S&Ls were to loan to customers within 50 miles of their office to build homes valued at $20,000 or less.

Several times through the history of the S&L, the movement fizzled or risked being coopted by business interests, but was saved by state and federal legislation aimed at preserving its purpose. For example, when the FDIC started insuring banks in 1933, deposits flowed out of S&Ls and into banks. In 1934, S&Ls were given deposit insurance through the Federal Savings and Loan Insurance Corporation. This made their continued existence viable by bringing them on par with mainstream banks.

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162 How A Good Idea Went Wrong, supra note __, at 645.
168 Hoffmann, supra note __, at 172.
169 Rodwin, supra note __, at 293–294 (describing the threat to S&Ls and legislation introduced by the Massachusetts legislature to preserve their purpose).
171 See Hoffmann, supra note __, at 173.
In addition to having their own insurance fund, S&Ls also had their own regulators because they functioned differently from traditional banks. The mechanisms of the S&L framework were deliberately and elegantly engineered to channel social resources into home ownership, and they served their purpose effectively for forty-five years. S&Ls drew in the modest deposits of their members and channeled those into home mortgages for low income families.

4. The S&L Drifts from its Mission

The S&L charters, which had grown increasingly popular over several decades, were slowly standardized and became an “industry” rather than a “movement.” Nevertheless, S&Ls continued for decades to fulfill their progressive mission to provide housing for low income Americans and continued to be mutually owned until the 1970s. However, the S&L industry failed disastrously in the late 70s and 80s for a variety of reasons, one of which is that it lost sight of its initial progressive purpose. While there are a lot of hypotheses offered to explain the colossal failure of the S&L industry, it is undisputed that the industry changed its focus from aiding the poor to seeking higher profits by mimicking traditional banks.

By the 1970s, mutual funds and Money Market Accounts (MMAs) had become popular and were drawing deposits away from banks and S&Ls, who were capped in how much interest they could pay for deposits. S&Ls joined banks in arguing for the repeal of Reg Q, the cap on interest rates. Reg Q was ultimately repealed. But the repeal of the interest rate cap posed a

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173 See HOFFMANN, supra note 2, at 173.
174 Id., at 178.
175 They also used resources of large investors. However, until 1958, the banks were over 95% funded by deposits. HORACE RUSSELL, SAVINGS AND LOAN ASSOCIATIONS 31, 651, Table 6 (1960).
176 Id.
177 Felsenfeld, supra note __, at S29.
178 Id. at S20; see also Anita Ingrid Lotz, Deregulation or Regulation: Money Market Mutual Funds and Other Illegitimate Offspring of the Banking and Securities Industry, 1 ANN. REV. BANKING L. 187, 201 (1982) (discussing the “competitive threat” money market accounts posed to depository institutions, and the “limited” ability of depository institutions to respond).
180 Felsenfeld, supra note __, at S20–S21.
181 Pub. L. No. 96-221, 94 Stat. 132 (1980); see also Felsenfeld, supra note __, at S20-S21.
problem for S&Ls, whose assets were primarily composed of long-term home loans that continued to pay interest at low rates. The sudden jump in rates S&Ls had to pay to attract deposits without a corresponding jump in rates being paid by their existing long-term borrowers meant that much more money was flowing out than in. S&Ls were caught in an interest rate squeeze. Instead of supporting the mission of the S&L, policymakers responded by deregulating S&Ls and allowing them to engage in shorter-term profit-making activities to bridge the profit and loss mismatch created by the sudden rise in market interest for deposits.

Deregulation of S&Ls coupled with advances in banking that allowed money to move quickly between financial institutions caused S&Ls to abandon their missions. Soon, S&L members and the communities that had supported them for decades abandoned these changed entities. They did so for two reasons. First, the interest rate on deposits became more important because investors could now shop for the highest interest rate regardless of the location of the institution. The rate of return became more important than “buying local” for higher wealth individuals. Second, these changes diminished the importance of community and joint ownership. As the industry became more national and disperse, communities and S&L members felt less of an obligation or a desire to invest with a their local bank because they knew that with the S&Ls expanded powers, the funds could now be used internationally and would not necessarily be used to build their communities. The national marketplace commoditized the lending business. S&L customers became less aware of how their S&Ls were operated, and became less resistant when S&Ls began to drift from their limited charters and engage in more mainstream banking activities.

5. Deregulation

In the early 1980s, the S&L industry underwent three phases of deregulation through the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980, regulatory changes by the Bank Board,

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182 Id.
183 Id.
184 PIZZO, FRICKER, & MUOLO, INSIDE JOB: THE LOOTING OF AMERICA’S SAVINGS AND LOANS 10 (1989); Felsenfeld, supra note __, at S15.
185 See Gail Otsuka Ayabe, The "Brokered Deposit" Regulation: A Response to the FDIC's and Fhlbb's Efforts to Limit Deposit Insurance, 33 UCLA L. REV. 594, 621 (1985) (Ayabe reasons that “differences in interest rates” offered at different deposit institutions “reflect . . . a competition for deposits. Depositors seek to place their funds in the financial institution that offers the highest rate.”).
and the Garn-St. Germain Act of 1982.\textsuperscript{187} DIDMCA repealed Reg Q and broadened S&Ls permissive activities.\textsuperscript{188} S&Ls could now offer credit cards and traditional interest-bearing checking accounts, as well as engage in commercial and general consumer lending.\textsuperscript{189} They could also invest up to 20\% of their assets in any combination of consumer loans, commercial paper, and corporate bonds, while commercial banks were still prohibited from investing in any type of securities.\textsuperscript{190} DIDMCA also increased FSLIC insurance from $40,000 per account to $100,000.\textsuperscript{191}

In 1983,\textsuperscript{192} the Federal Home Loan Bank Board further loosened regulations on S&Ls to allow them to invest in options and to buy and sell securities—both prohibited for commercial banks—and to offer variable-rate mortgages to shift some interest rate risk onto their customers.\textsuperscript{193} Regulators also lifted a 5\% cap on so-called “brokered deposits,” big bundles of accounts from pension funds, unions, or government agencies.\textsuperscript{194} Now, when an S&L needed an infusion of deposits, it could simply offer the highest interest rate for the day and arrange for brokers to deposit virtually as much money as was needed or wanted.\textsuperscript{195} S&Ls were growing larger and, due to more relaxed accounting standards allowed by federal regulators, taking larger risks.\textsuperscript{196}

In spite of these efforts to “save” the S&L industry it continued to mount record losses throughout the early 1980s.\textsuperscript{197} Congress passed the Garn-St. Germain Act in 1982 as another attempt to prop up the ailing industry.\textsuperscript{198} Under Garn-St. Germain, Congress increased the proportion of non-home-related loans S&Ls could make,\textsuperscript{199} dropped the down payment requirement for

\textsuperscript{188} Pub. L. No. 96–221, § 202.
\textsuperscript{189} Id. Title IV, §§ 401, 402.
\textsuperscript{191} Pub. L. No.96–221, § 308.
\textsuperscript{193} Id. at 23061.
\textsuperscript{194} Key Federal Regulatory Changes for S&Ls, 12 NO. 16 BANKING POL’Y REP. 6, 6 (1993); PIzzo, FRICKER, & MUolo, supra note __, at 19.
\textsuperscript{195} See Felsenfeld, supra note __, at S31
\textsuperscript{196} Id., at S32.
\textsuperscript{198} Id. at S314.
\textsuperscript{199} Pub. L. No. 97–320, § 322.
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home loans,200 and allowed S&Ls to be called “savings banks” rather than “savings and loans.”201 Through a Joint Resolution, Congress also placed the full faith and credit of the United States behind FSLIC insurance.202 At the same time, regulators loosened the regulations on who could own an S&L. Previously, an S&L was required to have at least 400 shareholders, with no one shareholder owning more than 25% of the stock.203 Now a single shareholder could own an S&L.204

In addition to these measures, the Federal Home Loan Bank Board, the primary regulator of S&Ls, stopped enforcing many of their existing regulations.205 Moreover, the number of regulators overseeing the industry was being reduced just as interest in owning and operating S&Ls was increasing. Since S&L deposits were FSLIC insured, and backed by the full faith and credit of the United States, S&L owners could deal fast and loose with deposits without having to worry about repercussions from depositors. Representative Jim Leach said about the S&L industry in the 1980s, “what has developed is a giveaway system where the potential profit has been privatized while the potential loss has been socialized.”206 Thus, the industry became an attractive target for many unscrupulous investors and organizations. The loosened regulations attracted the interest of anyone who wanted access to millions of FSLIC-insured dollars without much fear of close scrutiny from regulators, including people with ties to the mafia and other organized crime.207

202 PIZZO, FRICKER, & MUOLO, supra note __, at 13; Edward J. Kane, The High Cost of Incompletely Funding the FSLIC Shortage of Explicit Capital, 3 J. ECON. PERSP. 31, 41 (Autumn 1989).
204 PIZZO, FRICKER, & MUOLO, supra note __, at 13.
205 Barbara Crutchfield George, et al., supra note __, at 381; see also FDIC, HISTORY OF THE 80S, VOL. 1: AN EXAMINATION OF THE BANKING CRISES OF THE 1980S AND EARLY 1990S 170–72 (1997) (describing the internal shortcomings of the Federal Home Loan Bank Board, such as how the regulator was understaffed and under-qualified to supervise the industry after passage of DIDMCA and Garn-St. Germain).
206 PIZZO, FRICKER, & MUOLO, supra note __, at 312.
207 See generally id. (detailing the stories of several unscrupulous owners of S&Ls who recklessly established complicated schemes to launder money from S&Ls with little fear of
In 1987, President Reagan signed into law the Competitive Equality Banking Act (CEBA), which bailed out the S&L industry to the tune of $10.8 billion. Even then, industry observers knew this was far less than what was necessary to save the industry. Many S&Ls continued to fail during the 1980s with a total loss to the federal government of over $85 Billion dollars.

These deregulatory measures were envisioned to help the ailing S&L industry recover its market strength by allowing them to compete more directly with commercial banks. The neoliberal ideal that dominated the era had little regard for the S&L's unique mission and advocated for less government involvement and more freedom for S&Ls. This, it was thought, would save the industry. This assumption led S&Ls to look more like commercial banks. Although there is significant debate on the issue, many scholars have claimed that it was the deregulation of the industry that caused it to fail.

The deregulation of the industry certainly contributed to its collapse, but it is also true that the S&L mission could not survive the 1980s atmosphere without serious political support and support by the S&L industry itself, neither of which existed. It is also the case that by the 1980s, home

being caught by regulators); see generally JAMES B. STEWART, DEN OF THIEVES (1991) (narrating the story of the key players in the insider trading and junk bond scandals of the 1980s, including how S&Ls were targeted as vehicles to finance these speculative investments).

209 Id. § 301(e)(1)(b).  
210 See Arthur E. Wilmarth, Jr., The Expansion of State Bank Powers, the Federal Response, and the Case for Preserving the Dual Banking System, 58 FORDHAM L. REV. 1133, 1247 (1990) (attributing “the massive waive of failures that swept over the thrift industry” in part to Congress’ failure to pass a $15 billion recapitalization plan).  
212 See KATHLEEN DAY, S&L HELL 100 (1993); Id. at 1261; see also Felsenfeld, supra note __, at S33.  
213 Id. at 61.  
214 See, e.g., Felsenfeld, supra note __, at S36 (“Inadequate activity on the part of both federal and state regulators is widely cited as a reason for the S&L crisis . . . .”); Barbara Crutchfield George, et al., supra note __, at 380–85; Irvine Sprague, Unrelated Series of Events Led to S&L Crisis, AM. BANKER, May 3, 1989, at 4 (“[I]f we must point a finger, it would have to be directed toward the Reagan deregulation philosophy of ‘everything goes’ and ‘every man for himself.’”); Mark David Wallace, Life in the Boardroom After Firrea: A Revisionist Approach to Corporate in Insured Depository Institutions, 46 U. MIAMI L. REV. 1187, 1253–63 (1992). Others have concluded that the mission of the S&L—to increase home ownership—was the cause of its failure because it did not allow them to diversify into different products when the real estate market suffered. Felsenfeld, supra note __, at S48.
ownership was not the main financial obstacle of the poor because home financing was more accessible than at any other time.\footnote{215}{See Calder, supra note __, at 65-67.}

C. Morris Banks and Industrial Loan Companies

Morris Banks were a for-profit venture created to provide credit at low cost to low-income industrial workers. These banks were created by a financial innovation that enabled extending consumer credit without demanding collateral of the borrower.\footnote{216}{See O. Emre Ergungor & James B. Thomson, Industrial Loan Companies, Economic Commentary (Fed. Res. Bank of Cleveland), Oct. 1, 2006, at 1, http://www.clevelandfed.org/research/commentary/2006/1001.pdf.}

Morris banks later became known as Industrial Loan Companies (ILCs) or Industrial Banks (IBs).\footnote{217}{See id. Industrial Banks are today dramatically different from early Morris Banks and would have been an historical footnote were it not for the shifts in banking that made them the only banking charter that could be owned and controlled by a commercial bank.}

1. Born of Necessity

At the dawn of the 20th century, there was a great need for small-scale and short-term credit among the poor and working classes.\footnote{218}{See Grant, supra note __, at 76–110.}

No one was meeting the short-term credit needs of the poor for four primary reasons: (1) usury laws prevented traditional lenders from extending credit at profitable rates; (2) lenders were unable to distinguish between high- and low-risk borrowers who could not provide collateral, creating adverse selection problems; (3) public mores attached a stigma to both the client and the lender;\footnote{220}{Ergungor & Thomson, supra note __, at 1.}

(4) bankers were of the opinion that consumer loans were not a market for banking.\footnote{221}{See, e.g., Paul Hamilton, Jr., “You’ve Changed – We’ve Changed – “And We Must Now Change Even More!”, INDUSTRIAL BANKER, June–July 1971, at 7.}

In 1910, Arthur Morris, a Virginia lawyer who first coined the phrase “democratization of credit,” felt a personal motivation to meet the credit needs of the poor. He had observed that low- to moderate-level income earners lacking the necessary collateral but with a consistent history of income were unable to obtain loans through conventional commercial banks and were instead forced to turn to pawnbrokers or loan sharks for their credit needs.\footnote{222}{Inventory of the Papers of Arthur J. Morris: Biographical Sketch,}
Morris desired to correct this “weak spot” in the banking system and combed the existing laws in search of a solution that would “correct the existing evils and supply credit to the needy.”

2. An Innovative Solution

Arthur Morris was motivated to meet this need and was innovative in his approach. Morris, who was convinced that “80 percent of the American public was being denied adequate banking services,” designed a system whereby loans to the poor were made based on three principles: (1) character plus earning power is a proper basis of credit, (2) loans made on this basis of credit must carry the privilege of repayment over a period long enough to match the earning power of the borrower, and (3) money so borrowed should always be for some constructive and useful purpose.

From these principles Morris developed a system that replaced collateral with the signatures of two cosigners, both of whom agreed to pay the loan should the borrower default. This innovation in lending is still used today.

By requiring cosigners to the loan, the “Morris Plan” resolved the


224 PETER W. HERZOG, THE MORRIS PLAN OF INDUSTRIAL BANKING 12–13 (1928). For further illustration of Morris’s desire to supply credit to the poor and working classes, see Rural Credits: Joint Hearings before the Subcomms. of the Comms. on Banking and Currency of the S. and of the H. of Reps. Charged with the Investigation of Rural Credits, 63d Cong. 717 (1914) (Statement of Arthur J. Morris) (“The Morris plan is intended to correct . . . the loan-shark evil in the cities, and the present existing misapprehension that prevails in the mind of the laboring classes of this country habits of frugality, the value of systematized thrift . . . [and] was intended to be to the wage earner what the national banks are to the men of commerce.”); see also Providing for Control and Regulation of Bank Holding Companies: Hearings on S. 829 Before the Comm. on Banking and Currency, 80th Cong. 98 (1947) (Statement of Arthur J. Morris) (“[T]here was no person, firm, or corporation in this country prior to 1910 that were interested for 5 minutes in democratizing credit, and giving the honest wage earner any access to credit, regardless of his human necessities or his business opportunities or any other reason. . . . But I just made up my mind that these people deserved an access to monetary credit, and I started the first Morris Plan bank . . . for the sole purpose of making a start in the democratization of credit. By this I mean the making of loans to individual who has no security to offer for bank credit. I was not long in discovering the fact that more than 80 percent of the American public had no access to credit of any kind except as they resorted to loan sharks or charitable institutions.”).

225 HERZOG, supra note __, at 17.

226 Ergungor & Thomson, supra note __, at 1.
adverse selection problem that had historically vexed lenders. However, by itself, the cosigner innovation would not have been sufficient for proper entrance into the personal loan market. The legal hurdle of usury laws also needed to be overcome; otherwise, the lender could not make any profit. Morris also solved this problem through a “dual plan,” involving two separate transactions. The plan resulted in a system that could stay within the letter of the usury law but recoup the full cost of making relatively small, unsecured personal loans to unfamiliar borrowers. With his revolutionary new method of extending credit, Morris began establishing “Morris Plan” institutions in various cities around the United States and by 1928 there were 106 such institutions.

3. Embraced by the Law

While their expansion was swift, Morris Plan banks encountered some difficulty in obtaining charters because of confusion about the exact nature of the bank. In response to Morris’ original application for incorporation of his charter bank in Virginia, a member of the Virginia Corporation Commission responded by letter:

I have carefully considered your application for a charter for your hybrid and mongrel banking institution. Frankly, I don't know what it is. It isn't a savings bank; it isn't a state or national bank; it isn't a charity. It isn't anything I ever heard of before. Its principles seem sound, however, and its purposes admirable. But the reason that I am going to give you a charter is because I believe in you.

The first Morris Plan Bank, the Fidelity Savings & Trust Company, was opened in Norfolk in 1910 with the backing of state banking regulators.

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227 Id.
228 See M. K. Neifeld, Neifeld’s Manual on Consumer Credit 371 (1961). For a state-by-state list of statutory maximums extant near the time Morris started his business, see Franklin, supra note __, at 26.
229 Neifeld, supra note __, at 371.
230 Id.; see also Louis N. Robinson, The Morris Plan, 21 Am. Econ. Rev. 222, 222-23 (1931).
232 Mushinski & Phillips, supra note __, at 127.
233 Inventory of the Papers of Arthur J. Morris: Biographical Sketch, supra note __.
234 Grant, supra note __, at 92; see also Ralph N. Larson, The Future of Installment Banking, The Industrial Banker, Aug. 1962, at 12.
Arthur Morris set out on a vigorous campaign to encourage enactment of laws that would enable the Morris Banks to fulfill their mission of lending to low-income workers.\textsuperscript{235} By 1940, thirty-one states enacted specially-tailored legislation to support Morris Banks.\textsuperscript{236} In other states, Morris Banks operated under the state banking or even general corporation law.\textsuperscript{237} Thus, although united in name, the industry was divided in operations and, increasingly, in customer markets.\textsuperscript{238} Some Morris banks were operating under state usury laws while others pursued legitimacy through specialty or state banking laws. It was along these fault lines that the industry split into those that would continue to fulfill Arthur Morris’s vision of extending credit to the working class and those that pursued other clients for their business.\textsuperscript{239}

4. Competition from Other Banks and Loss of Mission

The principle reasons for Morris Banks converting to commercial banks were an increasingly competitive environment,\textsuperscript{240} changes in the legal and regulatory environment that incentivized or required the switch,\textsuperscript{241} and tax advantages available to owners of commercial banks that were not available to industrial bank owners.\textsuperscript{242} The primary driver of the Morris Bank’s downfall as originally conceived was the competition for consumer loans. Because these banks were not mutually owned like credit unions and S&Ls, but instead made profits for their owners, their products were quickly copied by mainstream banks that also wanted to capitalize on these loans.\textsuperscript{243} Expansion by commercial banks into consumer credit affected industrial banks most acutely “[s]ince commercial banks competed directly for Morris Plan clients, and could

\textsuperscript{235}See EVANS CLARK, FINANCING THE CONSUMER 69-70 (1931).

\textsuperscript{236}See Id.

\textsuperscript{237}See CLARK, supra note __, at 69-70.

\textsuperscript{238}See CALDER, supra note __, at 286.

\textsuperscript{239}Cf. A United Industry and One Strong Association, INDUSTRIAL BANKER, June-July 1971, at 5 (This article announces the merger of the American Industrial Bankers Association, publisher of INDUSTRIAL BANKER, with the National Consumer Finance Association. Significantly, the joined associations would maintain the name National Consumer Finance Association, while the AIBA would be subsumed as a section within the NCFA. Symbolic of the closeness that the personal finance industry (which had partially grown out of the entities regulated by the USLL) maintained with Morris’ original consumer, the industrial worker, this last edition of INDUSTRIAL BANKER ran an article entitled, Mobile Home Financing on page nine.).

\textsuperscript{240}SAULNIER, supra note __, at 169.

\textsuperscript{241}Id. at 54.

\textsuperscript{242}Id. at 53.

\textsuperscript{243}Id. at 169-70.
draw on much cheaper money.”

Commercial banks moved into consumer credit for a variety of reasons: lack of commercial loans during the Great Depression, a high demand for consumer credit, bankers’ increased familiarity with and belief in the soundness of installment loans, and a change in the classification of intermediate- and long-term loans. With commercial banks entering into the personal loan market, Morris Banks found themselves needing to compete for their customers’ dollars intensely and vigorously. Their strategy was twofold—expanding the types of loans they made and adopting commercial loan practices. By operating more like a commercial bank, Morris Banks, now called ILCs, found they could effectively compete. It was not much of a stretch for these institutions to go from operating like a commercial bank to converting into one, which is what happened with more and more regularity as the ILC grew further distant from its founding.

Although Morris Banks were attempting to democratize credit to low-income workers, they were a for-profit business from their creation. However, the high costs associated with making small, individual loans to those in desperate straits made it difficult for these banks to retain their

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244. CALDER, supra note __, at 286 n.70. “In both New York and the rest of the country, loan volume and outstandings of industrial banks fell dramatically from 1931 to 1934. . . . By 1936, co-maker loans comprised less than 50 per cent of total extensions of Morris Plan banks in New York State.”; DAVID H. ROGERS, CONSUMER BANKING IN NEW YORK 24–25 (1974). “Throughout the late 1930s, their average loan sizes were similar; and although the [industrial banks’] rates were somewhat higher than those of personal loan departments, the industrial banks were unquestionably a specialist in personal credit.” Id. at 37–38.

245. Id. at 116–17.

246. Id. at 213.

247. ROGERS, supra note __, at 37–38. Cf., CONSUMER CREDIT AND ITS USES 33-34 (Charles O. Hardy ed., 1938) (Eighteen different services are listed that the Morris Plan Industrial Bank of New York offered in 1938. These included Cunard-White Star Line travel loans, a plan to purchase furs, and a plan to finance memorials.).

248. Id. at 286 n.70.

249. NEIFELD, supra note __, at 380 (“[T]he dual plan institutions have departed widely from the original ideal which was to limit such an institution’s facilities to the individual with modest credit requirements. They now serve business and professional people as well. They have come more and more to resemble commercial banks and to employ conventional bank lending techniques and types of loans.”).

250. Id.

251. Id. at 371; Earnest A. Dauer, Radical Changes in Industrial Banks, 25 HARV. BUS. REV. 609, 617 (1947).
original mission after the founder, Arthur Morris, was no longer championing the cause. A statement by H. B. Jackson, Secretary of the Morris Plan Company of New York, illustrates this shift: “While the remedial loan was the entering wedge of the Morris Plan and must always remain an important part of our work, it is to the constructive loan that we look with the greatest expectation of results.” And while it may have been the wish of Arthur Morris to make the low-income wage earner the perpetual focus of its loans, the movement away from this original mission was accelerated by the simple fact that, even from the very beginning, Morris Plan institutions were locally owned and operated and would respond to the demands of those local owners. This rapid shift demonstrates that profit-seeking ownership will always search out the most efficient use of capital for the desired appetite for risk. Morris Banks quickly abandoned their mission and the legal and regulatory environment increasingly made commercial banks the attractive model for the ill-defined industrial bank.

5. Deregulation

In the 1980s, commercial firms became interested in acquiring so-called “non-bank banks,” or banks that were exempt from the Bank Holding Company Act (BHCA). Owning such a bank would allow commercial firms to enter banking without having to comply with the onerous regulations of the BHCA. The Competitive Equality Banking Act (CEBA) of 1987 closed the “non-bank bank” loophole, but specifically exempted ILCs because of a few well-placed senators whose states had a vested interest in chartering ILCs. The ILC loophole became one of the only and most attractive options

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254 See Morris Plan Bankers Convention, 105 BANKER’S MAGAZINE 924 (1922).
255 Id.
257 Id.
258 U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-05-621, INDUSTRIAL LOAN CORPORATIONS: RECENT ASSET GROWTH AND COMMERCIAL INTEREST HIGHLIGHT DIFFERENCES IN REGULATORY AUTHORITY 17 (2005) [hereinafter GAO, INDUSTRIAL LOAN CORPORATIONS]. A letter from former Federal Reserve Board Chair Alan Greenspan to Congressman Jim Leach suggests that perhaps the reason CEBA exempted ILCs from the definition of “banks” was because at the time CEBA was enacted the number of ILCs was small, their total assets were small, and most starts were not chartering or had a moratorium on chartering new ILCs. RANDALL DODD, FINANCIAL POLICY FORUM, INDUSTRIAL LOAN BANKS: REGULATORY LOOPHOLES AS BIG AS A WAL-MART (2006), available at http://www.financialpolicy.org/fpfspr13.htm.
259 DODD, supra note __. The FDIC summarized it this way: “[I]n 1988, the first commercially owned ILC applied for FDIC insurance. Once the precedent had been set, more
for a commercial firm to own a bank. Quickly after CEBA’s passage, large commercial firms, such as General Electric, General Motors, and American Express, started operating ILCs that they used to finance their own products. The ILC sector grew exponentially. Today, there are no ILCs that operate like their early predecessors. Their early mission is just a curious historical note.

D. Common Features of Banks that Served the Poor

Credit unions, S&Ls, and Morris Banks have several common features. First, these banks were born out of necessity. All three of these banks were used to meet the needs of the poor that were not being met by the banking institutions of the day. They were created outside of mainstream banking and with a different vision than most banks. Second, they were all innovative in addressing the needs of the poor. The S&L helped create the modern mortgage, the Morris Bank created the non-collateralized loan, and the credit union created formalized lending cooperatives. The S&L and credit union were both community-owned and controlled and emphasized personal relationships with the borrower as a proxy for high interest. Third, each was supported by the government and regulated differently than mainstream banks. This governmental support was essential in the expansion of each of these banks and allowed them to thrive despite obstacles in servicing their clients. Fourth, all of these banks changed course dramatically in the 1980s and have abandoned their primary mission of providing credit to the poor. Fifth, deregulation played a key role in each bank’s change of focus.

The following section describes some of the general changes in banking and society that explain why the poor are not being banked. These include changes in banking philosophy, including deregulation as well as changes in the demographics of the poor and the changing nature of their needs. Drawing on successful features of the credit union, S&L, and Morris Banks, this Article then describes a few programs launched by the government, the poor themselves, and non-profit organizations that may provide solutions to the problem of banking the poor.

applications followed.” West, supra note __.

260 DODD, supra note __.

261 Id.

262 Total assets grew from $3.8 billion to over $140 billion from 1987 to 2004. GAO, INDUSTRIAL LOAN CORPORATIONS, supra note __, at 5.
HOW THE POOR GOT CUT OUT OF BANKING

III. WELCOME TO POTTERSVILLE

In Frank Capra’s classic film “It’s a Wonderful Life,” Henry Potter, a heartless banker, tries to persuade George Bailey’s building and loan to stop providing home loans for the working poor. But George Bailey believes in the compassionate mission of his bank and starts up Bailey Park, an affordable housing project with the funds from his building and loan. In contrast, Henry Potter envisions maximizing profits for his bank by driving out the poor and getting the most out of his banks’ assets. In the movie, George Bailey triumphs with the help of an angel and a whole town’s support. But in American banking history, Henry Potter’s vision is the one that has actually come to pass. The contrast between Bailey’s and Potter’s banks illustrates the difference between running a building and loan that makes a profit, but has as its main objective servicing the working poor, and running a bank whose only aim is to maximize profits for its shareholders. Most mainstream banks today operate like Potter’s bank.

This section attempts to explain the sudden and dramatic shift in banking for the poor that occurred in the 1980s. Several specific factors caused the credit union, S&L and Morris Bank to shift their focus away from the poor and toward mainstream banking customers, many of which have been outlined above. However, there are broader shifts in banking and in society that also explain this change, which will be the focus of the following section. Below, this Article will discuss three generalized explanations of how the poor were cut out of banking: (1) market forces, such as changes in banking products, disintermediation, and financial innovation in the 1980s that put pressure on the traditional banking model; (2) deregulation in banking; and (3) social and cultural explanations for the banking sector’s abandonment of the poor.

A. Market Forces

During the 1980s, mainstream banks that used to dominate the financial market started to lose market share to the capital markets and unregulated financial entities, such as investment banks, mutual funds, and hedge funds. Banks were no longer the only option for investors. The sophistication of the capital markets and new financial products allowed institutional and individual investors to access the markets without needing intermediaries. Disintermediation caused a streamlining in the movement of credit to the benefit of many businesses. At the same time, financial innovation provided customers a variety of investment options, and they quickly became comfortable depositing their money in money market accounts or mutual...
funds and removing them from their non-interest bearing deposit accounts.  

Banks started to find ways around their regulations in order to participate in the financial bounty of the 1980s. During this time, most banks left the “storage business” (originating and holding loans) and moved to the “moving business” (taking loans from originators, repackaging them, and moving them to secondary market investors like pension funds). Where banks used to make money on the spread—the difference between what they received from borrowers and the interest paid to depositors—banks now focused on fees for transactions. The easy profits from transactions distracted many banks from their core functions, and banks stopped lending to small- and medium-sized businesses in pursuit of ever higher fees. Banks, which had operated a boring and safe business plan for many decades became exciting, innovative, and much more profitable.

With the introduction of the money market account in the 1980s that paid high interest and allowed customers liquidity (the ability to write checks on the account), banks were forced to compete for large deposits and cut costs, including services previously offered to low-income customers. Both the S&L and the credit union were casualties of the increased competitive environment. Both of these banks joined the competition for deposits and were forced to shed unprofitable accounts in order to stay above water.

The number of people with bank accounts declined starting in the 1980s, especially among the low-income sector due to “an increase in fees on deposit accounts with small balances.” The GAO conducted an extensive report on these changes and prompted an additional study by the Federal Reserve that supported the finding that banks were indeed shedding low-income customers due to higher fees on checking accounts. Banks also

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263 Under these circumstances, bankers became increasingly resistant to government regulations that kept them from competing with non-banking entities and looked for ways to shed their regulatory chains. See Ebonya Washington, The Impact of Banking and Fringe Banking Regulation on the Number of Unbanked Americans, 41 J. HUM. RESOURCES 106, 111–12 (2006); CARL FELSENFELD, BANKING REGULATION IN THE UNITED STATES 47 (2004).


265 Id. at 84.

266 Id. at 5–6.

267 CASKEY, supra note __, at 88–89.

268 See id. at 86.

269 Id. at 87.

270 See id. at 86–90.

271 Id..
began closing branches in low-income areas leaving many low-income neighborhoods with no physical access to any banking institution. These branch closings especially impacted African Americans and Hispanics living in urban areas. Once the banks left low-income communities, fringe banks moved in with staggering numbers.

During this time, banking also moved from focusing on a local market toward taking advantage of economies of scale and seeking a national presence. The impact on the poor from this change cannot be understated. In the age of boring banks, banks had a presence in a community and their assets and liabilities stayed within the community. Such was the model of George Bailey’s bank as well as the S&L and credit union. Funds would gather in a bank and stay there, which allowed the rich in the community to subsidize loans to the poor. As banking and banks became more complex in their operations, they also became more global and less local. Money no longer had to stay in the community in which a depositor resided. If those assets could be used more efficiently in another market, they would move there—either through bank branching or banking affiliates. The advantage to this movement and complexity is the rate at which money could grow and make profits by being put to its most efficient use. Unfortunately, giving small loans to the poor at low interest is not an efficient way to grow money and thus most banks stopped doing it.

B. Financial Deregulation

The rules of banking were changed to match the changed landscape. Banks lobbied vigorously for deregulation and for limited government intrusion into the banking market. The gradual deregulation of banks expanded from the Carter to the second Bush Administrations. The banking sector thought that government regulation was stifling market competition and that they could operate more profitably and efficiently without it. Proponents of deregulation advocated a banking regime that was as close to a free market as possible. There were many changes during this time, but most relevant

272 Id. at 87, 90–91.
273 Id. at 94–95.
274 See supra Part I.C. and accompanying notes.
275 See generally, THOMAS F. CARGILL AND GILLIAN GARCIA, FINANCIAL DEREGULATION AND MONETARY CONTROL (1982). Cargill and García argue that the problem with the structure of the financial system in the United States, beginning with reform legislation following the Great Depression through the 1970s, was that it constrained competition. Id. at 11.
here was the homogenization of banking.\textsuperscript{276} As a result of the deregulation, most banks resembled each other in their mission and purpose.

The pluralism in banking was more or less abandoned and a more homogenized sector emerged. What this meant was that banks were all treated as market participants and forced to compete against each other for the same deposits and customers. The goals of the credit union and S&L were slowly lost and replaced by the demands of a competitive banking market. Many banks started to vigorously oppose the credit unions’ favorable tax status as they started to compete more directly with banks.\textsuperscript{277} Many believed that the banking market could meet the needs of the poor without these specially chartered institutions. Indeed, some have even claimed that securitization was the market’s answer to the home-ownership goals of the S&Ls.\textsuperscript{278} As a natural extension, increased securitization during the housing bubble should have been the ultimate fulfillment of the American dream rather than a major setback.

After the collapse of the financial markets, few people today would advocate for the deregulation that was pushed in the 1980s. Many policymakers recognize now that the recent banking collapse was at least partly caused by the no-holds-barred deregulation of the 1980s that allowed banks to become larger and more active in a variety of markets.\textsuperscript{279} The Dodd-Frank Act of 2010\textsuperscript{280} (Dodd Frank) is, at least theoretically, a re-stiffening of banking

\begin{footnotesize}
\begin{enumerate}
\item Banks and policymakers fought against tax advantages and other “special privileges for credit unions and S&Ls. See G. Allen Hicks, \textit{Common Sense on the Common Bond: Banks, Federal Credit Unions, and Field of Membership Rules}, 66 TENN. L. REV. 1201, 1219-20 (1999).
\end{enumerate}
\end{footnotesize}
regulation and a reasserting of regulatory control over banks. However, as policy-makers have begun to question some of the principles of deregulation, none have drawn attention to some of the important victims of deregulation: the banks that used to serve the poor.

C. Social and Cultural Changes

There are other possible explanations for why banking institutions stopped serving the poor that are focused on the poor themselves. These potential explanations can be summarized as follows: (1) banking institutions were victims of their own success—they graduated the poor into the middle class, solved the problem they were created to address, or are no longer needed to service the poor; and (2) that the poor are now poorer than before and do not have sufficient funds to be banked.

1. The Problem was Solved

This argument posits that when the S&L and credit union were created, the populace was much poorer than they are today. These institutions started in an era when there was more rampant poverty with less government support. It is indeed the case that American society has softened the blow of poverty since the Great Depression due to government safety nets; thus there is more recourse for the destitute today than before. However, poverty remains and is increasing. In September 2011, the Census Bureau reported that “the number of Americans living below the official poverty line, 46.2 million people, was the highest number in the 52 years the bureau has been publishing figures on it.” The report also warned of increased income inequality, wage stagnation, and rampant unemployment. Poverty has always been and continues to be a reality for many Americans.

a. The Poor Have Access to Credit

Some claim that credit is abundantly available to the poor and that the problem they face is not that they are under-serviced by the credit industry,
but over-served. This argument relies on the widespread availability of fringe banking. However, as mentioned above, the fringe banking industry does not provide healthy credit options for the poor—credit that allows them to escape poverty. Aiding the poor is not about increasing the quantity of credit available, but the quality of credit. The reason the credit union, S&L and the Morris Bank were successful in their missions is that they offered credit that was low-cost and flexible.

Others claim that what the poor need is financial education in order to take advantage of smart credit as opposed to high-cost credit. They claim that those that are poor are poor because they do not have the financial understanding of the middle class. Financial education is indeed necessary to overcome poverty. There are many factors that cause endemic poverty and lack of education is an important contributor. However, many of the working poor know the difference between good credit and bad credit, but due to their economic status are only offered the latter. Many assume that the poor do not understand the financial system and that they must be taught how it works. This is not necessarily the case. Many of the poor are balancing a variety of debts from different lenders and juggling multiple payments with very few assets and resources. In many respects, they are better versed in the financial system than many in the middle-class because they are in daily contact with money, debt and credit. Thus, it is not financial literacy that they most need, but institutional access that meets their specific needs.

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285 Cf. GARY RIVLIN, BROKE, USA: FROM PAWNSHOPS TO POVERTY, INC.—HOW THE WORKING POOR BECAME BIG BUSINESS (2010) (discussing the variety of financial services offered by the multibillion-dollar fringe banking industry).

286 See LENA ROBINSON ET AL., FEDERAL RESERVE BANK OF SAN FRANISCO, GUIDE TO FINANCIAL LITERACY 1 (2002), available at http://www.frbsf.org/community/webresources/bankersguide.pdf (“Consumers who understand the merits of responsibly managing their financial resources are more likely to effectively and profitably utilize the services of a traditional financial institution.”) The Economist, Getting it Right on the Money, THE ECONOMIST, Apr. 3, 2008.”), available at http://www.economist.com/node/10958702; (stating that “many poor people do not have a bank account—and that few of them understand why this puts them at a disadvantage (let alone other essentials of personal finance) . . .”)

287 LENA ET AL., supra note 329, at 1 (“Financial literacy can . . . break the cycle of poverty, which is often associated with the unbanked.”); Lusardi, supra note 329, at 2 (linking financial illiteracy to failure to plan for retirement, lack of participation in the stock market, and poor borrowing behavior).

288 See sources cited supra note 329.

289 Mann & Hawkings, supra note __, at 876.

2. Too Poor to Bank

The argument that the poor are too poor for bank accounts has some support in the historic data. John Caskey believes that lower income is the main cause for the decrease in bank accounts. In other words, apart from the changes in banking, people just do not have enough money to save anything at all. The poor are simply poorer now than they were in the past. Caskey identifies several social changes that led to lower income for the poor, including the loss of low-skilled jobs, increased immigration and an increase in single-parent homes. According to Caskey, lower income is one factor that led to the poor gradually moving away from mainstream banks and toward fringe lenders. This does not mean, however, that the poor do not need banks. They may not benefit from a savings accounts, but as demonstrated above, they do need short-term credit.

IV. SOLUTIONS FOR BANKING TO THE POOR

A. Enlisting Mainstream Banks

Since the era of deregulation, government efforts to provide banking services to the poor have centered on mainstream banks. Policy makers have tried both carrot and stick measures in an attempt to get these banks to lend to the poor. Most of these initiatives have been unsuccessful.

1. FDIC Pilot Program

The most recent attempt by policymakers to induce mainstream banks to lend to the poor was launched in February 2008. The FDIC began the “Small-Dollar Loan Pilot Program,” a two-year campaign to enlist mainstream banks to loan to the poor. 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.” The program enlisted 28 volunteer banks to offer banking services that the poor needed, such as payday loans and check-cashing.

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291 Caskey, supra note __, at 102-03.
292 Id. at 108.
293 Id. at 100.
294 Id. at 105 (“the decline in account ownership mainly reflected a deterioration in the economic situation of households in the lower end of the income distribution….”)
Congress’ Committee on Financial Services met in September of 2011 to review the program and many were in agreement that the program had failed. Observers noted that banks were charging the maximum rates allowed in the program—36% APR and 20% charges on cashed checks. Some noted that these products were “just like payday loans.” Other congressmen resisted forcing mainstream banks to take on the risk of lending to the poor. Although the program resulted in some unbanked individuals forging new relationships with banks, the banks offered products that were not much more desirable than those offered by fringe banks and the banks did not design new procedures or products that might be more attractive to the poor.

The main reason this program failed is that mainstream banks do not have the incentive to sacrifice profits in order 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. The reason that the credit union, S&L and Morris Banks were able to successfully reach the poor was because they were motivated to do so. In fact, that was their primary goal. Policymakers misunderstand the nature of mainstream banks if they are relying on them to adequately meet the needs of the poor. At best, they can be incentivized to do it in order to appease regulators. The products they offer are not innovative attempts that are the product of market research about what the poor really need—they offer the bare minimum so that they can maintain profitability while fulfilling a regulatory mandate. Forcing banks whose purpose is to make maximum profits to make loans to the poor will inevitably lead to inadequate loans and disgruntled bankers.

2. Community Reinvestment Act

Government efforts such as the Community Reinvestment Act (CRA) attempt to remedy discriminatory behavior such as redlining, but also encourage banks to lend in low-income communities. The CRA views the lending markets through an affirmative action framework and imposes duties on banks to lend to under-served communities. The CRA represents government imposition of social norms on the banking market and forces

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296 Availability of Credit Hearing, supra note __; Wack, supra note __.
297 Availability of Credit Hearing, supra note __.
298 Many of the banks volunteered for the program because they were told that they would be fulfilling their CRA requirements.
commercial banks to serve markets that they have deemed unprofitable.\textsuperscript{300} As such, it has been controversial. Professors Macey and Miller have criticized the CRA by stating that it “promotes the concentration of assets in geographically nondiversified locations, encourages banks to make unprofitable and risky investment and product line decisions, and penalizes banks that seek to reduce costs by consolidating services or closing or relocating branches.”\textsuperscript{301}

Proponents of the CRA counter these claims by showing that the Act has indeed increased lending to low income communities and led to more branch openings in these underserved areas.\textsuperscript{302} But most commentators agree that the enforcement of the CRA has been weak and has not brought about the desired results.\textsuperscript{303}

There is a robust debate about the effectiveness and appropriateness of the CRA which this article will not engage, except to posit that regardless of its effects on low-income communities, the CRA relies on banks whose main purpose is to maximize profits to meet the needs of the poor. As one scholar has reasoned: “In an industry of banks of many types and sizes, without credit quotas and with institutional decision-making left to bank managers, the best the CRA can do is to prescribe inexact guidelines and then ask that bureaucrats apply these guidelines to various real-world situations on a case-by-case basis.” Unfortunately, as the literature on bureaucratic management suggests, in this sort of environment, more attention will be paid to the imperatives of the bureaucracy than to the underlying goal of serving the poor.\textsuperscript{304}

And because the underlying goal of mainstream banks is to maximize profits, the CRA is ripe for manipulation. During the financial crisis, there have been reports that “at least in some instances, the CRA has served as a catalyst, inducing banks to enter underserved markets that they might

\textsuperscript{300} Macey & Miller, supra note __, at 295.
\textsuperscript{301} Id. at 291.
\textsuperscript{303} See id. at 603 (“CRA’s broad standards and enforcement mechanisms . . . have long been derided by both proponents and detractors of CRA. Community advocates urge stricter rules and harsher consequences of failure. Bankers lament the lack of clear rules or safe harbors and the intrusive role of the public.”); Charles W. Calomiris et al., Housing-Finance Intervention and Private Incentives: Helping Minorities and the Poor, 26 J. MONEY, CREDIT & BANKING 634, 637–38 (1994) (“[T]he vagueness of the CRA has led to arbitrary enforcement.”); Keith N. Hylton, Banks and Inner Cities: Market and Regulatory Obstacles to Development Lending, 17 YALE J. REG. 197, 203 (2000) (explaining that that enforcement of the CRA has been uneven and unpredictable); Macey & Miller, supra note __, at 328 (describing the view that enforcement of the CRA is subjective and uncertain).
\textsuperscript{304} Taibi, supra note __, at 1513.
otherwise have ignored” and giving those people unfavorable loans. 305 “Recent problems in mortgage markets illustrate that an underlying assumption of the CRA—that more lending equals better outcomes for local communities may not always hold.” 306 The CRA’s emphasis on the number of loans given as opposed to the quality of the loans has revealed itself to be a problematic measure of success.

The debate over the CRA implicates two broader questions about providing banking for the poor; first, whether mainstream commercial banks should be tasked with providing these services, and second, whether they can do it in a way that is beneficial to the poor? In other words, if a bank whose bottom line is to maximize profits is forced by the regulators to offer services to the poor, will this lead to harmful products or manipulation of regulatory loopholes? Indeed, these banks are not equipped to meet the needs of the poor and their incentives to maximize profits run counter to the needs of the poor.

B. Community Development Banking Act

As banking history demonstrates, banks that are designed to meet the needs of the poor are successful when they have the support of the government, when they are motivated to meet the needs of the poor, and also when they are able to forsake large profits. Through the Community Development Banking Act (CDBA), the idea of community-centered banks, or banks that would receive funding from the government or other sources and would specialize in providing financial services to poor communities, had a short-lived resurgence. But the model has not yet succeeded because it has not yet been fully supported by the government.

ShoreBank in Chicago started as an experiment in which community activists bought a struggling bank and began lending in an impoverished area with apparent success in transforming the area. 307 Bill Clinton, after visiting the bank in 1985, wanted to make it a model for low income communities and made a campaign promise that he would establish one hundred such banks


306 Id.

across the country.\textsuperscript{308} The campaign promise was transformed into legislative action in 1994. The Riegle Community Development and Regulatory Improvement Act commonly known as the Community Development Banking Act (CDBA)\textsuperscript{309} was intended “to promote economic revitalization and community development through investment in and assistance to community development financial institutions…”\textsuperscript{310} The act provided for a fund that would support any Community Development Financial Institution (CDFI), which it defined as an institution that has “a primary mission of promoting community development, serves an investment area or targeted population, and provides development services in conjunction with equity investments or loans.”\textsuperscript{311}

Congress, however, never appropriated the full amount authorized by CDBA for the Community Development Financial Institutions Fund (CDFI Fund), which would enable government investments in community banks.\textsuperscript{312} The Bush Administration also sharply reduced funds to the CDFI.\textsuperscript{313} These funds have never been robust or popular. In fact, the press and the banking community have largely ignored these banks because they are still relatively small in number and a large portion of the funds are dispersed among various community development initiatives.\textsuperscript{314} According to the fund’s financial disclosure, the majority of investments have gone, first, to real estate development in low income communities and, second, to businesses operating in those areas.\textsuperscript{315} In other words, the majority of the funds have not been used to provide what the majority of the poor need, such as short-term credit.

From the start, the framework of the CDBA was stuck in the modern banking model and based on the faulty premise that these banks could


\textsuperscript{310} 12 U.S.C. 4701(b).

\textsuperscript{311} 12 U.S.C. § 103, http://thomas.loc.gov/cgi-bin/query/F?c103:4:.\temp/~c1038wHx8de1065

\textsuperscript{312} Id. at 398, Table 1, 397. The fund was also brought within the purview of the Treasury Department in 1996 and has been mentioned as one of the accomplishments of the Clinton administration. Id. at 398.

\textsuperscript{313} Katie Keuhner-Hebert, CDFI Fund Appropriation Could Increase to $100 M, AM. BANKER, June 13, 2007, at 4.

\textsuperscript{314} See Lehn Benjamin et al., \textit{Community Development Financial Institutions: Current Issues and Future Prospects}, 26 J. URBAN AFFAIRS 177, 179 (2004).

\textsuperscript{315} Id at 178.
maintain high levels of profitability while serving the poor. The needs of the poor would be met without any adjustment to free market rules and with minimal government intervention. It was thought that these institutions would lend profitably to low-income communities, achieve significant returns on investments, and thereby induce mainstream financial institutions to join them in providing credit to the poor. Secretary Treasury Lawrence Summers envisioned “[a] successful CDFI [as] perhaps best compared to a niche venture capital firm that deploys its superior knowledge of an emerging market niche to invest and manage risk better than other investors.” Summers envisioned these banks as “market scouts” that would seek out profits in over-looked markets. CDBA’s were meant to be private institutions seeking profits while serving the poor. Donald Lash, an early CDBA advocate, claimed that competition in banking would open the way for CDFIs to expand in response to market needs.

Many in the banking community lauded ShoreBank as a model of profitability as well as community-mindedness. Here was a bank that could serve the poor and make profits for its investors. The vision of the CDFI Fund was that without structural changes to the banking framework, profit-maximizing institutions could be induced through modest funds and incentives to meet the needs of struggling communities. But this was not the vision of ShoreBank, which was started by civil rights activists in Chicago with the aim of serving the direct needs of the community, with an ambitious slogan, “Let’s change the world.”

Because these banks were forced to work in the dominant banking model, many have recently failed or are in trouble. In 2010, ShoreBank was

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316 Lash, supra note __, at 399.
318 Id.
319 Lash, supra note __, at 401.
320 See, e.g., Rochelle E. Lento, Community Development Banking Strategy for Revitalizing Our Communities, 27 U. Mich. J. L. Ref. 773, 783-790 (“Shorebank presents a success story in the community development banking world. As of May 1991, its total loan portfolio was $125 million, with a delinquency rate of 1-2%, a bit lower than the national average of 3-5%. In 1992, it had $244 million in assets and a net income of $1.60 million. Shorebank demonstrates that deliberate investment in disinvested communities can revive a local economy, rekindle the imagination of its people, and restore market forces to health and interdependency.”).
Even before the financial crisis wrought havoc on small banking nation-wide, these institutions were struggling to remain profitable. Compared to their more conventional peers, CDFIs routinely show weaker financial performance. “An analysis of the financial performance from 1996 to 2000, of [113 CDFIs] relative to their peers, found that the CDFIs typically had fewer total assets, higher loan delinquency and charge-off rates, and lower returns on assets.”

The way CDFIs operate is simply more costly than their traditional counterparts and their objectives would be thwarted if they attempted to offset their risks with too high interest rates.

Part of the problem with the CDBA was that the legislation was not aspirational enough in its scope and mission. Although it was modeled after the bold vision of the ShoreBank, the CDBA was not intended to change the business of banking to meet the needs of the poor, but to fit the needs of the poor into the business of banking. Unlike the progressive and populist movements that brought about the credit union and the S&L, the CDBA movement is dependent in the current banking structure and does not attempt to subvert the institutional profit-seeking model in banking. By offering financial incentives to mainstream banks to reach out to the poor, the CDBA expects these banks to do the heavy lifting without changing the competitive environment of banking or offering significant subsidies. Thus the CDBA is the proverbial carrot as the CRA was the stick—both attempting to coax mainstream banks to do something that is inherently inconsistent with their business model.

Despite the failure of the model to expand nationwide and survive financial distress, the CDBA should not be abandoned, but refined. Primarily, the model needs to escape the profit-centered ideology of modern banking in order to allow these institutions to function. If these banks are to continue to offer needed services to the poor, they must be able to function with minimal profits and maximum government support. Lending to the poor is not a profitable business and the government must not outsource this important social need to the mainstream banking model. Congress must adequately subsidize this lending if it is to be effective.

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C. Movements Led by the Poor

1. Informal Lending Circles

As noted above, mainstream banks and the modern banking model fails to provide appropriate services to the poor because they lack the motivation to do so. Effective banking to the poor may require that the communities themselves be involved, just as they were in the formation of the credit union and S&L. The poor themselves know what they lack and what they need and should be empowered to organize movements that meet their own credit needs. However, in order to be successful, they must have government support and access to the formal banking infrastructure.

An example of self-help financing is the lending circle model that is prevalent both in the U.S. and abroad. In the U.S., undocumented workers and many immigrant groups have organized informal “lending circles” whereby a group of individuals pools resources and picks a member of the group by lot to receive a loan. These informal lending circles resemble the early credit unions and have roughly the same goal of providing credit to their members outside of formal markets. These groups can overcome informational asymmetries and transaction costs that are often the most important barriers for mainstream institutions lending credit to immigrant and poor communities.

These informal lending circles resemble the microcredit model of the Grameen bank and other international non-profits. There have been multiple attempts at establishing formal micro-credit ventures in the US that have been organized on the principles underlying the Grameen Bank in Bangladesh, but many have suffered from setbacks and hurdles, such as lack of informal markets as well as geographical and social impediments. Furthermore, the microcredit model is useful for small businesses and entrepreneurial ventures, but is not a model that can meet the short-term credit needs of the poor.

326 See id.; Light & Pham, supra note __, at 39.
327 Id. at 884–88.
328 Solomon, supra note __, at 191.
The communities that develop these informal lending circles are usually tight-knit and share a cultural bond or language. These groups are formed on mutual trust, which is “faithful to the Latin from which ‘credit’ derives: credere—‘to believe.” And belief is something that mainstream lenders lack when it comes to assessing the creditworthiness of immigrants, minorities, and the poor. Thus, these credit circles are designed to overcome market inefficiencies and allow capital formation and growth among tight-knit communities. Studies in New York’s Chinatown and California’s Japanese communities reveal that these institutions are the dominant form of banking among these groups. A staggering 80% of Koreans in the US belonged to at least one informal credit group. These groups optimize community wealth, do not rely on any government enforcement or intrusion, and are entirely self-funded.

These groups are seen as alternative markets formed to deal with market imperfections, an arrangement that bolsters the dominant free market model. They operate outside the mainstream banking model as a “borrower’s solution to market imperfections, a consumer-driven arrangement that is a solution to an inherent market deficiency soluble neither by state regulation nor by open market arrangements.” These groups are an essential feature of the informal credit market and preferable to for-profit fringe banking that is currently filling gaps in the mainstream banking sector at high costs. But these alternative markets do not interact with or inform the mainstream markets.

Despite the attractiveness and desirability of such a solution to the problems facing the poor, these groups are not an adequate remedy for several reasons: First, these groups do not have any formal relationship with traditional banks, which is problematic because their members are not able to develop a credit history and enter mainstream banking. Additionally, their deposits are not protected and their investments are vulnerable to fraud or mismanagement by others. Second, while these groups may be an answer for tight-knit groups of immigrants with a shared language and culture, they do not arise among the large majority of American urban and rural poor who do not share dominant social norms. In addition, they only serve those on the

330 Cao, supra note __.
332 Cao, supra note __, at 878.
333 Id. at 880-881.
335 Cao, supra note __, at 863.
fringe of the mainstream markets who have community support and not the destitute or those completely cut off from any help. Third, credit is no less costly from these groups than from alternative lending sources. Members can pay up to 20% interest on loans, which means that these funds are funds of last resort or necessary because of lack of another alternative. Lastly, these groups cannot help with emergency or every day credit needs, which continues to be the domain of loan sharks or payday loans.

2. Formal Lending Circles

One way to remedy some of the shortcomings outlined above is to formalize these lending circles, which was essentially the success of the credit union movement. Informal lending circles resemble the early credit unions and building and loans, but they lack the governmental support that allowed these institutions to thrive and expand. However, these lending circles can forge partnerships with banks and give their members the ability to build credit and open bank accounts. One example of such an arrangement was initiated by the Mission Asset Fund (MAF) in San Francisco, which has linked a lending circle, called a “Cesta” with Citibank. MAF serves as a credit servicer that bridges the gap between the pooled assets of the lending circle and the formal banking system. The fund currently services Spanish-speaking immigrants. All of the members are required to have a bank account and the payments are automatically drawn from the individuals in each lending circle and given out electronically as well. These transactions are also reported to the credit bureau, helping members build a positive credit history. The group claims a zero default rate and a successful education initiative for its members. The MAF model has just received a grant from the Center for Financial Services

336 Light & Pham, supra note __, at 41–42.
337 Cao, supra note __, at 877–78.
339 Id.
340 See id.
343 See MAF Lending Circles, supra note __.
Innovation (CFSI) and will attempt to replicate its model among Chinese immigrants, African Americans, Middle-Eastern immigrants, and the LGBT communities in San Francisco.\textsuperscript{344}

A formalized lending circle has the capacity to overcome some of the weaknesses in the informal lending model by formalizing these arrangements in order to gain the benefits of FDIC insurance and establishing credit. As mentioned above, many of the poor prefer informality in lending and institutions that can feign informality, such as check-cashers, have capitalized on this preference. The MAF attempts to do the same, but without a motive to make large profits. However, this model is limited in reach and in scope. It relies on bankers willing to forge these partnerships and there may only be a finite number of knowledgeable bankers altruistic enough to engage in such an enterprise. Moreover, only members can benefit from the fund and members must commit funds to the lending circle in order to participate. These funds do not provide short-term credit and do not replace the services of fringe banks or offer the scope of services offered by the credit union, S&L and Morris Banks.

\textit{D. Post Office Banking}

In addition to supporting innovative movements led by the poor themselves, policy-makers should consider initiating alternative banking forms that would provide much-needed services to the large unbanked population. Instead of relying on the commercial banking sector to fill the gaps in banking, government sponsored institutions could meet these needs. As demonstrated by the credit union and S&L industries, a successful movement must be embraced by the government and replicated nationwide. One option is to re-enlist the postal service and use an existing, but struggling, government resource to meet a pressing policy objective. As mentioned above, the government has used the postal service in the past to enable savings accounts by the poor. Post offices can be used as a way to offer short-term, low interest credit to low-income Americans. Just as credit unions and S&Ls of the past, the postal service could operate through minimal government subsidies and still maintain modest profits.

The post office could offer check-cashing and payday lending services much like those offered by fringe banks, but at a much lower cost. It could also offer them without all the documentary and formality barriers of banks. There are currently non-banks, other than fringe lenders, that are starting to offer these products because they do not involve sophisticated credit analysis.

\textsuperscript{344} See MAF Lending Circles, supra note __.
or any regulatory support, such as FDIC deposit insurance. For example, Wal-Mart recently started to offer simple credit options, such as check cashing at a discount to its customers in its stores with much acclaim. The postal service would function as a very basic credit intermediary. Fringe banks do not need to have a banking charter to offer these simple types of credit so banking laws would not apply to such an arrangement. There would certainly be a need to hire trained staff and design uniform underwriting protocol, but as demonstrated by the fringe banking industry, which makes high margins of profit by offering relatively low-risk credit, the service does not require any specialized expertise.

The U.S. Postal system is struggling to maintain profitability and relevance as its services slowly become obsolete due to the internet and other technological advances. By rethinking the purpose of the postal service and its many existing branches, the postal service might be saved and a serious public need could be met. Launching such a system would certainly require some up-front costs and marketing, but the costs of maintaining such a system would not have to be large. Customers would still pay a fee to cash a check, but the fee would not be as high as they currently pay. Operating through the postal service would sacrifice some of the flexibility and innovation of the credit union and S&L movements, but the government subsidy and support would go a long way in providing access. The post office already exists in all neighborhoods and people of all classes and cultures have had interactions with the postal service. Thus, the barriers of access do not exist as they do with mainstream commercial banks.

The poor pay more for credit than any other sector of the population and private companies profit from that spread. The government could step into this sector and offer lower cost credit options to the poor by only taking into account the actual cost of credit and forgoing large profit margins. For example, many members of the military currently use fringe lenders to turn their government-backed pay checks into cash. There is virtually no risk associated with a government check, but members of the military pay astronomical fees for this service. If the postal service could offer to turn these checks into cash and only take account the actual costs of the credit, members of the military could take home more of their hard-earned paychecks. These services could be offered to the poor across the country without using banks as an intermediary.

Government-sponsored student loans operate under this premise. A student borrower who qualifies for such a loan receives credit at a lower than 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. 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 U.S. in recent years and solve a variety of public problems.

Enacting such a wide-scale change may not be politically feasible. Legislators have shown a lack of motivation to regulate the fringe banking industry in the past, mainly due to the lobbying strength of the sector. Any attempts by the government to compete with the sector with the low-costs alternatives proposed here would surely be vigorously opposed by the fringe banking lobby. However, after the Great Depression, President Roosevelt made significant and unpopular changes to the banking structure, like strengthening the S&L and the Credit union, which made banking more accessible to the poor. These changes were a response to an outcry by Americans who were economically suffering. President Roosevelt seized the economic upheaval of the 1930s to overcome similar political hurdles. A banking crisis often presents such an opportunity for enacting changes that benefit the public and we again have the opportunity to re-envision the banking sector.

CONCLUSION

“Poor people are not just like rich people without money….Poverty creates an abrasive interface with society; poor people are always bumping into sharp legal things.” Thus, they cannot be banked just like rich people with less money. The poor often have different financial habits, culture and preferences than the middle-class, such as a desire for informality and a need for short-term credit. A banking structure aimed at meeting their needs would have to be responsive to these preferences if it is to successfully replace the pernicious fringe banks that are currently dominating financial services to the poor.


348 Stephen Wexler, Practicing Law for Poor People, 79 YALE L.J. 1049, 1050.
Currently, many of the poor only access the financial system through fringe banks that operate at high-costs to them. This type of credit keeps the poor indebted with crippling interest rates for long periods of time, introducing additional barriers to their escape from poverty. The poor use these institutions because there are currently no banks designed to meet their needs. This was not always the case. In the past, the government has supported banks with a special mission of meeting the needs of the poor, such as credit unions, S&Ls, and Morris banks.

These successful charters aimed to provide credit and access for the poor and shared a few common traits: they were born of necessity, they were created outside the dominant banking framework, they were innovative, and they had the support of the government. Yet all of these institutions have abandoned their initial missions due to structural and philosophical changes in the banking framework. This Article identifies trends in modern banking that have resulted in a homogenization of bank structure across the industry, which has left little room for banks seeking to serve disadvantaged communities. Such trends include deregulation and structural changes in the banking sector that have caused all banks to compete with each other for higher profit margins.

Since the demise of these institutions, there have been several attempts to force mainstream banks to meet the needs of the poor—all of which have failed. Mainstream banks have been unable to offer productive products because of their unwillingness and inability to reduce profits. In order to properly serve the disadvantaged in this country, some more lucrative ventures must be sacrificed.

The credit union, S&L and Morris Banks show that a bank must operate outside of the mainstream banking culture as well as have the support of the government to succeed. Thus, this article proposes several alternatives banking structures that would meet the needs of the poor, such as providing more support for the CDBA system, promoting formal lending circles, or using the postal service to offer check-cashing and payday lending services. Above all, this article highlights the void in banking the poor and attempts to revive the public purpose of banks.