A free-market agenda Maxine Waters can support

Diego Zuluaga

February 27, 2019

The American banking system is poised for a revolution — one driven by technology and competition — but on Capitol Hill, it's facing a traffic jam. Maxine Waters, a progressive firebrand, chairs the House Financial Services Committee. The Senate remains under Republican control. The White House, for all its deregulatory pronouncements, seems too busy with other issues to devote much energy to major legislative changes to financial regulation.

Is this a recipe for gridlock? Maybe. But inaction would hurt millions of Americans who stand to benefit from greater access to innovative financial services. Moreover, increasing financial inclusion and lowering the regulatory burden on financial firms are not incompatible goals. In fact, a free-market agenda can achieve both. Despite the political conflict, there's a clear route for some much-needed reforms — places where both conservatives and progressives like Waters can find some common ground.

Waters wants to be a champion for those currently underserved by the U.S. financial system. There are many of the so-called unbanked: According to the Federal Deposit Insurance Corporation, 6.5 percent of U.S. households (8.4 million families) lack a bank account. For minorities and the poor, the share is much higher: 16.9 percent of African-American households and 14 percent of Hispanic ones lack a bank account, compared with just 3 percent of white households.

The persistently large number of unbanked Americans is symptomatic of a major problem. Ownership of a bank account enables people to build a credit history, making it easier to borrow in the future. Banking relationships allow families to plan their expenditures and investments, to safely store their savings and to earn a return on them. Progressives worry that millions of Americans might be held back if they lack a bank account. Conservatives who support free enterprise should be concerned that government over-regulation has raised the cost to banks of managing accounts, pricing out lower-income people in particular.

Indeed, cost is a major reason why millions of families do not use banks. A majority of the unbanked cite not having enough funds as a reason to forgo an account, presumably because they would be subject to fees for having a balance that is either too low or negative. A further 20 percent mention high and unpredictable account fees. Others find bank hours and locations inconvenient. Worryingly, 59 percent of the unbanked say they're "not at all likely" to open a bank account in the next year.

This is true despite the fast pace of innovation in consumer credit. Since 2007, there has been a rapid growth of technology-enabled financial firms, so-called "fintech" companies, that provide financial services outside the traditional bricks-and-mortar banking system. These fintech lenders use sophisticated risk assessment and lower operating costs to partially replace banks in credit markets such as mortgage lending, from which they retreated after the financial crisis.

Waters herself declared last month that she had "great hopes that fintech firms can open up opportunities for those who have been excluded from access to responsible credit."

Recent evidence from the Federal Reserve Bank of Philadelphia vindicates her hopes. Fintech firms show a higher penetration with consumers in underserved communities, an auspicious finding considering the growing phenomenon of "banking deserts" (areas without a single bank branch within a 10-mile radius), which currently affects 3.7 million Americans. Other Fed research shows that the alternative credit-scoring models used by fintech lenders — new systems that don't rely as much on the traditional FICO credit score — do a better job of estimating the risk of default, opening the prospect of affordable credit to a larger base of customers.

The banking landscape that Waters faces is therefore one in which barriers to access persist, but where innovation is steadily expanding inclusion. To progressives, that is a priority because exclusion from banking and credit particularly affects historically disadvantaged minorities. Furthermore, financial inclusion can bolster income mobility by facilitating borrowing for entrepreneurship and investment. To those of a free-market bent, financial inclusion is desirable because no individual or group should be prevented from dealing with other people for mutual benefit.

Here are three ways the House Financial Services Committee can work to expand access to banking that can gain the support of both progressives and free-marketers.

First, Waters should work with the Senate to clarify that loans which were lawful at origination remain lawful when sold to third parties, and that a bank's business relationships with a nonbank supplier do not affect the legal treatment of the bank's loans. Both principles have ample judicial precedent, but a New York federal judge recently threw them into jeopardy in a decision in a case known as *Madden v. Midland*.

Without legislative reassurance, state caps on interest rates would make it difficult for banks to sell their loans to other lenders, because banks are exempt from the caps but nonbank financial firms are not. Banks would also face barriers to partnering with fintech firms for marketing purposes. Both effects would raise the cost of lending, with an adverse impact on consumers. In fact, there's already evidence that credit has become scarcer and more expensive in the states covered by the *Madden* ruling. A legislative fix, by contrast, is likely to expand the range of options available to consumers.

Next, Waters' committee should review the 1970 Bank Secrecy Act. The BSA was aimed at curbing money laundering, the process of turning funds earned through illegal activities into legitimate-looking assets such as real estate. Banks are required to file reports on every cash transaction over $10,000 and some above $5,000 — a compliance nightmare for small banks, accounting for nearly a quarterof their regulatory costs.

The BSA is ineffective at prosecuting serious financial crimes: Out of more than 5 million reports of suspicious transactions filed in 2018, only 20 percent related to major public concerns such as money laundering, terrorism, and cybercrime. The Treasury Department's enforcement division undertook just three enforcement actions in 2018, and just five in 2017. The IRS reports a decline in money laundering and BSA-related investigations from 2014 to 2016, the last year for which figures are available. Looking at the data, it seems that the deluge of reports makes tackling serious crime more difficult, not easier.

The BSA particularly affects low-income and minority Americans, who are more likely to drop out of, and remain outside, the banking system when account fees rise due to higher compliance costs. Maintaining a bank account costs bank managers a fixed amount per account holder; and the more compliance costs rise, the higher the minimum account balance required to offset those costs. In that way, BSA regulations harm low-income Americans in particular.

Waters should, for a start, push for adjusting the threshold for reporting transactions in accordance with inflation. She should also look to narrow the range of activities for which reports must be filed, so that law enforcement authorities can focus limited resources on the most pressing threats. These reforms would make the BSA less burdensome, less likely to harm lower-income households, and better-focused on targeting national security threats. Both progressives and conservatives can support those objectives.

Finally, Waters should encourage continued review of the Community Reinvestment Act. Research has shown this 40-year-old legislation to be out of step with the more competitive U.S. banking market that has developed over the past two decades. The CRA may also be encouraging riskier lending by banks, at the expense of taxpayers. Expanding its reach to fintech lenders and credit unions, as some have advocated, would at best have no effect — since both already serve vulnerable communities — and at worst hasten the decline of branches and raise these lenders' cost of capital. Progressives could more effectively boost the provision of banking and credit to underserved communities by facilitating entry, instead of raising the cost of operating branches and lending to low-income borrowers. Free-market conservatives, in turn, should cherish winding down onerous regulations that force banks to compromise on their soundness.

The above set of measures will serve the interests of both progressives like Waters, conservatives like her Republican Senate counterpart, Mike Crapo, and all those who believe that free and competitive markets are key for delivering broad-based prosperity. This agenda promotes innovation and competition, while expanding access to mortgage and business credit to communities that have historically been shut out of financial services. If Waters is willing to harness the power of innovation in the pursuit of greater access to banking, not only will she gain strong support from those of a free-market persuasion; she will succeed in helping those most in need.

Diego Zuluaga is a policy analyst at the Cato Institute's Center for Monetary and Financial Alternatives.