



A Fundamental Need: Small-Dollar, Short- Term Credit

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Executive Summary

A dramatic series of events related to small-dollar value, short-term credit has unfolded over the last 18 months. Legislators, regulators, and the financial services industry have been closely scrutinizing the payday loan industry and creating market incentives for private-sector innovation. As a result, the landscape has changed.

Consumers have always needed small amounts of credit, although that need has been filled in different ways. In the United States, the market for short-term, small-dollar credit has a long history. As banks over time stepped away from these small-dollar loans in favor of credit cards and overdraft-type services, alternative providers arose to meet the demand. Evolving from personal finance companies, payday lenders had developed into the dominant source for such loans by the 1990s.

Consumers have paid a high toll for the rise of payday lenders. With fees generally ranging from \$15 to \$30 for every \$100 borrowed and a repayment structure that can lead to frequent loan flips, a short-term loan can easily turn into a long-term problem. In response to the recent scrutiny, the FDIC has established guidelines and a pilot loan program to encourage banks to offer payday alternatives as a business opportunity that would also earn Community Reinvestment Act credits. The need for increased innovation will continue to grow as the regulatory environment makes it more difficult for payday lenders to operate.

Regardless, innovation has been growing within the financial services industry, laying a foundation for better service for this market niche, salary advance-type products, a downscaling of credit lines, and new installment loan products.

Salary-advance loan products are now available through several credit unions on both an individual and a cooperative basis. These products offer much of the utility of a payday loan but are more consumer friendly, with lower fees and sometimes with savings components. All of these offerings directly acknowledge the growth of payday loans and seek to provide a more valuable and economical service to their member consumers.

Along with credit unions, several banks have sought to answer this market demand by offering small lines of credit as well as salary advance-type products. These products are designed to provide access to short-term financing along with installment repayments. They are available in addition to current overdraft products. Some banks now offer advance products, charging borrowers \$2 per \$20 advanced, equivalent to an APR of 120 percent. Other providers have developed lower-dollar-limit line-of-credit products to address the same market need but for a slightly different customer. These services have expanded the options available to consumers.

The FDIC's two-year Small-Dollar Pilot program is also examining best practices for banks offering small-dollar loans. With 30 banks participating, the program will review profitability, demand, and operations of a small-dollar loan product available through financial institutions. Significantly, the pilot is also testing the 36 percent APR interest rate cap and seeking to determine whether the economics of small-dollar loans are the same for large and small banks. Given their different infrastructures, underwriting models and related functions could present critical differences.

The influx of microlending to the United States recalls the time when credit approvals were largely interpersonal and manually underwritten. Some time will be needed to evaluate the success of these new underwriting processes. The ability to lend based upon a deep knowledge of a community and the borrower has proved critical to the success of micro-lending activities outside of the United States.

So what does it all mean? The use of payday lenders and related alternative financial outlets has shown that underbanked consumers frequently have difficulty obtaining cost-effective services for small-dollar value, short-term credit needs. To meet this consumer demand, a broader suite of such credit products are needed. These products will not succeed, however, unless they are developed and delivered in a way that is both fair to the consumer and profitable to the service provider.

From a product perspective, the subtleties of pricing and repayment are the critical elements of a successful small-dollar loan product. While the proper price point for these loans is not yet clear, it is obvious that to build demand, the products must be priced fairly, have effective and timely risk-management procedures, and be delivered cost effectively for the service provider and the consumer. They must also incorporate realistic repayment schedules so the consumer can establish a positive pathway to savings and away from debt. Only thus will a long-term relationship be established.

Introduction

A dramatic series of events related to small-dollar value, short-term credit has unfolded over the last 18 months. As the payday loan industry has come under increasing scrutiny, legislators, regulators, and industry itself have all taken actions that have radically changed the financial services landscape and provided incentives for private-sector innovation. This report summarizes the context that led us to this point, provides a high-level overview of innovation in the marketplace, and analyzes the key strategic considerations as we move forward. We also review relevant research literature regarding payday loans.

Market Background

Consumers have always needed small amounts of credit, but that need has been filled in different ways. The market for short-term, small-dollar credit has a long history in the United States. State-sanctioned small-dollar lenders first emerged early in the 20th century. Previously, unregulated small lending operations had skirted strict state usury laws, charging higher rates through additional fees and other tactics. In the 1910s, progressive reformers and unregulated “loan sharks” seeking to legitimize their industry formed an unlikely coalition to back a Uniform Small Loan Law in state legislatures. By 1932, 25 states had adopted the law.

The law loosened usury ceilings on small loans, defined as \$300 or less, while prohibiting additional fees; required lenders to be licensed and bonded by the state; and imposed restrictions on the practice of salary buying. While some “loan sharks” flaunted these reforms, many small-loan lenders willingly submitted to the new laws to improve their public image. By the end of the 1920s, they had recast themselves as “personal finance companies.” These companies viewed themselves as a fundamental aspect of industrial capitalism, providing thrifty workers with infusions of cash to smooth consumption during rough patches. In the years following World War II, consumer credit rose to new heights with the expansion of installment lending and the introduction of the credit card. While continuing to offer small cash loans, finance companies had already begun to diversify their product base, especially in larger, more profitable loans.

Beginning in the late 1970s, banks and finance companies started making fewer small, unsecured personal loans in response to a variety of pressures. Deregulation and intensifying competition in the banking industry led banks to reduce many services they had traditionally offered at a low profit or a loss, such as small loans. Newly permitted consolidation in the industry led to the closing or acquisition of many small, community-based institutions, and the relationship-based lending practices made possible by small local banks became harder to find. Deregulation also allowed finance companies to enter markets traditionally served by banks in greater force, such as home equity lending. Finance companies shifted resources away from costly unsecured personal loans toward these sectors.

Banks and finance companies alike also paid more attention to credit cards, de-emphasizing other forms of unsecured consumer credit. The widespread adoption of computers during this period made approval for revolving credit lines faster and less expensive, while approval of personal loans remained relatively costly. As manual procedures declined, one unintended

consequence was that low-income consumers who were new to credit, lacking records in these new systems, often had a harder time gaining approvals and thus access to credit.

The need for short-term borrowing and the lack of options paved the way for substantial growth in alternative sources of short-term credit for lower-income borrowers. Pawnbroker operations, a centuries-old institution, initially filled this vacuum, growing rapidly throughout the 1980s. By the late 1990s, however, pawnbrokers faced growing competition from the emerging payday loan industry, which offered greater convenience and access.

Payday Lending: A Demand and a Concern

To most consumers, a payday loan seems more attractive than a pawnbroker. Rather than handing over personal possessions as collateral to a pawnbroker, the borrower gives the payday lender a postdated personal check, a bank statement, and basic identification. Somewhere between 30 minutes and 48 hours, he or she receives the needed funds.

Payday lending formally emerged in 1996 with the passing of California Senate Bill 1959.¹ The bill legalized deferred deposits of checks, the basic mechanism of a payday loan. Requiring written agreements for deferred deposit transactions, the bill also required disclosure of any fees to be charged for a deferred deposit. Several states followed California, and today payday lending is regulated largely state by state.

The payday lending market, with more than 22,000 payday lending stores² across the United States, now rivals the scale of some traditional banks. With minimal barriers to entry and strong consumer demand, the industry has grown rapidly and, as a whole, remains highly fragmented. Unnoticed by many observers, the numbers have risen from roughly 2,000 lending U.S. storefronts in 1996 to its current 22,000—a 24 percent compound annual growth rate. The Community Financial Services Association of America (CFSA), a payday lending industry advocacy group, estimated that payday lenders provided roughly \$40 billion a year in loans and \$6 billion in finance charges in 2004.³

As the use of these lenders has grown, so too has the scrutiny under which they are monitored. Fees of \$15 to \$30 per \$100 borrowed (approaching percentage rate of 400 percent, if viewed on an APR basis) have raised the ire and consternation of banks, regulators, and consumer groups alike. Unlike traditional depository institutions and finance companies with diverse offerings and funding sources, payday lenders rely largely on fees to fund their operations. They attribute high operational costs and associated prices to the loss rates on these loans, which may be 10 to 20 percent.⁴ However, even with the high costs, many consumers of payday loans appear to value their convenience, timeliness, and lack of credit checking. That perceived value,

¹ California Senate Bill 1959: http://info.sen.ca.gov/pub/95-96/bil/sen/sb_1951-2000/sb_1959_bill_960923_chaptered.html.

² Community Financial Services Association of America (CFSA) estimate, <http://www.cfsa.net/policymakers/overview.html>.

³ Community Financial Services Association of America (CFSA) estimate as quoted in *USA Today*, "Payday Lenders Use Internet to Avoid Law," December 1, 2004.

⁴ John P. Caskey, "Fringe Banking and the Rise of Payday Lending," in Bolton and Rosenthal, eds., *Credit Markets for the Poor* (2005), p. 5.

though, might be somewhat misunderstood by repeat customers, who may fail to realize the full cost of the loans.

Research has shown that many payday borrowers roll over loans multiple times, paying repeated fees on the same loan when they can't overcome a financial shortfall within a single pay period. Rolling over loans can trap borrowers in a cycle of ever-increasing costs, to the point that borrowers may end up owing more than the initial loan amount.⁵

Recent federal regulatory efforts have begun to address some aspects of these loans, primarily interest rates, via the Talent Amendment. The Talent Amendment was passed in 2006 and took effect in October 2007. It seeks to limit payday lending activities around military bases by imposing a 36 annual percentage rate cap on loans to military members and their families. This APR cap includes the total of all fees imposed.

The goal of the Talent Amendment and the resulting Department of Defense rules is to encourage military members and their families to avoid high priced lenders and when in need to look to Military Aid Societies (such as the Army Emergency Relief or the Air Force Aid Society), military banks, and defense credit unions when in financial need.⁶ The impact of these DOD rules are that many payday lenders may have decided to exit these markets and not to lend to military personnel rather than reduce their interest rates to comply with the new regulations.⁷

In the wake of such developments, the FDIC recently issued guidelines to encourage banks to offer payday alternatives as a business opportunity that would also earn Community Reinvestment Act credit. Among the guidelines was a recommended maximum rate of 36 percent, though with allowances for setup fees.

FDIC: Small-Dollar Loan Guidelines Begin to Emerge

The 2007 FDIC guidelines are focused on ensuring that small-dollar loan products are affordable to consumers while retaining the other features that make them attractive to both lenders and consumers. Some of the FDIC's key recommendations encourage lenders to offer an APR of 36 percent, structured repayment programs, timely underwriting, savings opportunities, and financial education.⁸

The FDIC has also begun a two-year project to review small-dollar loan programs with 30 financial institutions of varied sizes and locales. The study is designed to identify business practices to help banks incorporate affordable small-dollar loans into their mainstream offerings. In May 2008, the FDIC began collecting data from the participating banks to evaluate their experiences with small-dollar lending. They will evaluate the structure of the loans offered and the cost/benefits to both the financial institution and the consumer.

⁵ Center for Responsible Lending, "Financial Quicksand," 2007.

⁶ *Federal Register*, 32 CFR Part 232, "Limitations on Terms of Consumer Credit Extended to Service Members and Dependents; Final Rule," August 2007.

⁷ Lee Davidson, "Payday Lenders Tell Military 'No,'" *Deseret Morning News*, October 2, 2007.

⁸ FDIC, *Affordable Small-Dollar Guidelines*, 2007.

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Since it appears that a large percentage, if not most, consumers obtaining payday loans have bank accounts, then, at least in theory, a small-dollar loan offering by a consumer's bank should be attractive to the consumer. The risk-management underwriting of payday lenders, or general lack thereof, could present a barrier for most banks, however. Since the pricing of payday lenders appears to include the cost of anticipated defaults, banks maintaining a 36 percent APR interest rate cap may be at an economic disadvantage.

While the formal purpose of the study is to highlight effective practices and to help banks bring affordable small-dollar loans to their mainstream banking services, testing the 36 APR interest rate cap may yield a potentially more significant result. It will also be critical to determine if the economics of these small-dollar loans are the same for large and small banks. Their different infrastructures, underwriting models, and related functions could pose significant differences.

It will be more advantageous to continue to work to open avenues for further competition and innovation. Increased competition, and certainly new innovations, can spur expanded activity that could ultimately help to lower the cost of short-term loans for both the financial service provider and the consumer.

Nonetheless many developments have already occurred to better serve this market niche.

Beyond Payday Loans: The Financial Services Industry Responds

The use of payday lending highlights a fundamental question: given the large demand, where else do consumers turn when they need a small-dollar loan for a short time and lack access to credit? The financial services industry has begun to develop products that meet the demand. These efforts can be categorized as: salary advance-type products, FDIC small-dollar loan pilot program, a downscaling of credit lines, and new installment loan products with microfinance.

Salary Advance Products: Credit Unions

Several individual credit unions and credit union organizations have begun to offer salary advance loan products that can provide the utility of a payday loan but in a more consumer-friendly fashion. All of these offerings directly acknowledge the growth of payday loans and seek to provide a more valuable and economical service to their members.

Smaller credit unions face significant challenges in addressing these needs. The product development, marketing, and inherent risk exposure of small-dollar, short-term loans is often too costly for single credit unions to undertake on their own. To overcome this barrier, credit unions in both Pennsylvania⁹ and Ohio¹⁰ have cooperated to develop their payday alternative loan offerings. In 2007, the Ohio StretchPay program's 31 credit unions provided over 64,000 loans totaling \$25 million. The Better Choice program in Pennsylvania issued 5,706 loans totaling \$2.7 million.

⁹ Pennsylvania Credit Union Better Choice: <http://www.pacreditunions.com/betterchoice.html>.

¹⁰ Ohio Credit Union StretchPay: <http://www.ohiocreditunions.org/StretchPay.htm>.

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Both programs provide the benefits of a payday loan without the potential rollover traps. To prevent a rollover cycle, loans provided by the credit unions under the Pennsylvania Credit Union Association Credit Union Better Choice and the Ohio StretchPay programs are required to be repaid in full before another loan is obtained. The programs also include financial literacy for borrowers. The Pennsylvania program contains a savings component that requires depositing an additional amount, equal to 10 percent of the loan, into a savings account in the borrower's name. This savings amount is not available for withdrawal until the loan is repaid. When the loan term ends, the consumer has \$50 in a savings account.

One of the largest credit unions in the nation, the North Carolina State Employees' Credit Union, has independently developed a salary advance loan product.¹¹ Like the Pennsylvania program, the NCSECU salary advance contains a savings component with five percent of the advance placed into a credit union cash account as collateral. This cash account earns interest and has some access restrictions. A lending official from the credit union must approve all withdrawals from the cash advance account to help the consumer with financial control. If a withdrawal is approved, borrowing privileges on the loan may be suspended for a time. Since 2001, the salary advance loan program has served nearly 100,000 members with advances of over \$1 billion.

Chicago's North Side Federal Credit Union was one of the earliest to address the need for a payday alternative. As with the other credit union programs, a borrower is limited to one loan at a time. After a year of membership and good performance, borrowers can qualify for a Hot Cash/Cold Funds loan, which extends the repayment period to one year and lowers the origination fee to \$10.¹²

This chart shows how the credit union programs compare.

¹¹ North Carolina State Employees' Credit Union: <http://www.ncsecu.org/Loans/SalaryAdvance.html>.

¹² National Community Investment Fund, "Lessons Learnt from Implementation by NCIF Retail Financial Services Participants," Chicago, May 2007.

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Table 1: Credit union Comparison

	Pennsylvania Credit Union Better Choice	Ohio StretchPay	North Carolina Salary Advance	North Side Payday Alternative
Loan Terms				
Max Amount	\$500	\$500	\$500	\$500
Min Amount	\$100	\$250	None	None
Max Term (days)	90	30	30	180
Interest Rate (APR basis)	12.0%	16.5%	12.0%	16.5%
Application Fee	\$25	\$35-\$70 annually	None	\$30
Late Fee	None	None	None	\$10
Additional Items				
Savings Required?	Yes	None	Yes	\$75 is held until loan completion
Financial Literacy?	Yes	Yes	None	Yes

Salary Advance Products: Banks

Several banks have also begun to respond to the market need by offering lines of credit in addition to advance-type products. These products provide access to short-term financing that is repaid in installments. These services supplement current overdraft products. Unlike overdraft products, where the simple act of overdrawing on an account triggers the service, the salary advance products require customers to request and apply for the funds. While depository institutions generally charge less for these advances than payday lenders, fees are still substantially higher, on an annualized basis, than other forms of credit offered by banks.

Both Wells Fargo and U.S. Bank now offer advance products. Both charge borrowers \$2 per \$20 advanced, equivalent to an APR of 120 percent. Wells Fargo's Direct Deposit Advance service allows account holders who receive a monthly direct deposit exceeding \$100 to access the advance line of credit through an ATM. Credit limits for both the Wells Fargo and U.S. Bank products are set at the lesser of \$500 or half of the individual's monthly direct deposit income. The advance is repaid from the next direct deposit into the account that is greater than \$100, and the entire advance must be repaid within 35 days. Under Wells Fargo's terms, customers who use the product in more than 12 consecutive statement periods see their credit limit reduced by \$100 in each subsequent statement unless they refrain from using it for a month. U.S. Bank restricts usage for three months if a customer takes advances in nine consecutive months.

FDIC Small-Dollar Loan Pilot

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As mentioned earlier, the banks participating in the FDIC pilot are experimenting with a variety of innovations. For example, Mitchell Bank of Milwaukee is offering a payday loan alternative lending from \$300 to \$1,000 to customers of at least six months. The loan terms are repaid in six- or 12-month amortization periods. A consumer's APR is based upon his or her credit score. A minimum of \$1,000 in monthly income is required in addition to a credit report for each application.

If the consumer scores below 570, he or she is required to participate in credit counseling, may borrow no more than \$500, and must have 20 percent of the loan amount pledged as security to a designated savings account. The rates can range from 15 percent for the highest range of credit scores to 22 percent for the lowest. A \$12 application fee is required, and a \$10 fee is assessed for late payment.

The Mitchell Bank loan's limitations and savings components share some features with the credit union products previously discussed. No more than two loans can be taken within a 12-month period, and borrowers are required to deposit 10 percent of the loan amount into a savings account with withdrawal restrictions. Of particular benefit, the deposits have an interest rate 1 percent higher than equivalent passbook or statement savings accounts. Mitchell Bank anticipates continuing to offer the loan product after the pilot program ends.

The Savings Bank of Wakefield, Massachusetts, created a small-dollar loan product before the pilot program, intending it as a payday loan alternative. Interestingly, The Savings Bank's product is open to non-customers as well as current customers. The loans take the form of a closed-end, simple interest loan. Ranging from \$300 to \$1,000, the loans are available at an 18 percent APR interest rate (the same as their unsecured overdraft line of credit). Repayment terms range from 18 months (for a \$300 to \$500 principal) to 36 months (for a \$501 to \$1,000 principal). A credit report is processed for all applications.

As with the Mitchell Bank product, The Savings Bank product includes a savings component, requiring 5 percent of the loan amount be held in a savings account. The loan amount is distributed via this passbook savings account—a behavioral element intended to instill the habit of saving. Loan customers are instructed in how to use the savings account and encouraged to withdraw only the amount required for the immediate need.

In offering small-dollar loans to non-customers, The Savings Bank's strategy is to gain access to new client prospects. The bank is marketing this service through local community organizations. These organizations not only help the bank find prospective borrowers by asking them to refer prospects but also identify other community organizations that might be interested in the product offering. The advantage of community-based organization referrals is their vested interest in relationships and presence in the community.

Still More Options: Line of Credit Innovations

While prepaid products may expand eligibility beyond the limitations posed by requiring a checking account, H&R Block's Emerald Card, with a \$500 line of credit, addresses risk another way. Borrowers must pay back an initial loan in full by a specified date to qualify for the revolving line. To repay the loan amount, consumers may choose to have their tax returns direct deposited to their Emerald Card and then must arrange either to make a transfer payment from their Emerald Card to pay down their line of credit, or send a check or money order by the payment date.

Clients can extend their lines of credit year-round either by having a minimum \$500 of their paycheck direct deposited per month to the Emerald Card to receive an unsecured \$300 line of credit at 36 percent APR, or by depositing at least \$300 (up to \$1,000) into their savings account to secure a line of credit in the amount equal to the savings deposit. This line of credit secured with savings has a 9 percent APR. While the ability to obtain a loan and repay it with tax refunds is unique to the tax-preparation business, the other elements of this service are applicable to other service providers.

Launched in 2008, MetaBank now offers iAdvance, a line of credit integrated with select Meta-issued prepaid programs. In signing up for iAdvance, consumers using Meta-issued prepaid cards can borrow small amounts via the card. The amounts are taken in \$20 increments as often as desired, up to a defined credit limit. A fee of \$2.50 is assessed with each \$20 taken (150 percent APR). If a cardholder uses the advance service for more than 12 consecutive months, the cardholder's credit limit is gradually reduced. Advances and fees are automatically repaid out of subsequent direct deposits.

Expected to be launched in the fall of 2008, the next generation of iAdvance will offer a credit graduation process to the core product, whereby a significant percentage of consumers will find themselves graduating to increasingly lower borrowing costs and the opportunity to payoff over time. And like today, the enrollment and advance processes will take less than two minutes, funds are immediately available to borrowers on their MetaBank-issued prepaid card and repayment performance is reported to the three major credit bureaus.

Other banks are also experimenting with existing line-of-credit products by reducing the credit size. Citibank's Checking Plus allows checking account holders to automatically draw on a line of credit if their account is overdrawn, or access funds up to a given credit limit directly, up to a maximum \$10,000. Checking account holders can apply online, be approved instantly, and receive their line in three or four days. The APR for this line is 17.25 percent in all states but New York (where it is 16.75 percent), and there is a \$5 annual fee for the service (outside of New York and Illinois). The APR is subject to a 2 percent increase in the case of a default.

In the past, most banks made such products available to the majority of consumers, but over time they've become out of reach for many, if not most, lower-income consumers. The size of the credit lines, the effort involved in applying, and information required for underwriting have also helped to reduce the profitability of these services and thus their availability. In addition, the increased profitability and use of overdraft products have simply pushed many credit-line-type products from the market. As overdraft protection products draw greater regulatory and

legislative scrutiny, banks may increase their efforts to develop credit line products that can be offered to a broader array of customers.

New Installment Loan Products: Global Microfinance Models Arrive in the United States

The interpersonal, relationship-based loan is making a comeback—but in a new form. The model looks back to the time when credit approvals were largely interpersonal and manual, before they became primarily automated as they are today. The ability to lend based upon a deep knowledge of a community and the borrower has proved critical to the success of microlending outside of the United States. Seeing the same needs in the United States, several entities have begun to import these programs. Time will tell whether demand exists for these programs and how successful their underwriting processes are.

One such example is Progress Financial, a non-bank finance company that has developed a variation on the installment loan focusing on the needs of Hispanic borrowers. Marketed as Progreso Financiero, the company offers unsecured installment loans from \$500 to \$5,000 (\$500 to \$1,800 for first-time borrowers), via Latino supermarkets. The company markets and distributes its services within large retail grocery stores, charges interest rates well below typical payday-loan APRs (no more than \$100 in total interest for a typical eight-month loan with a 15 percent APR), and underwrites the loans based on a proprietary model tailored to its targeted borrowers. Progress developed its proprietary underwriting model by evaluating several credit companies in Latin America that have been able to demonstrate profitable lending to the poor. To apply for a loan, a consumer provides identification, proof of address, and proof of income, along with an extensive application that evaluates over 100 data points. Loan applications are generally processed within seven days.

Microfinance International Corporation's (MFIC) Alante Financial also focuses on Latino consumers, offering consumer and small business loan programs modeled after microfinancing in Latin America. With brick-and-mortar branch locations in Delaware, Maryland, Virginia, and Washington, D.C., it offers a mix of financial services, including microloans (\$500 to \$5,000), remittances, check cashing, and insurance. Its loan products conform to the small dollar loan guidelines issued by the FDIC in 2007.

A recent import to the US is Grameen America who recently launched an initial effort in Queens, NY. Grameen is trying to use the successful model of Grameen Bank of Bangladesh that was created by Dr. Muhammad Yunus, the 2006 Nobel Peace Prize recipient. Grameen America is a microfinance company specifically aiming to serve poor entrepreneurs, many of whom are unbanked. Grameen uses a community, peer-based model that seeks to take advantage of all aspects of interpersonal/relationship-based lending.¹³

When entering a community, Grameen evaluates the viability of operating there. If it is deemed viable, Grameen brings together interested borrowers, organizing them into groups of five individuals known as peer groups. Each member of the peer group then gives a loan and is encouraged to help support the other group members during their start-up phase. Loans are

¹³ Grameen America, "How It Works": <http://www.grameenamerica.com/howitworks.html>.

provided at 15% interest with no additional fees. They are repaid in equal amounts over 52 weeks.

The strength of the peer group is that if a single borrower fails to demonstrate consistent loan repayment and financial behavior (such as saving), the entire group becomes ineligible for future lending until the individual who has not repaid his or her loan does so. This peer configuration encourages all the borrowers to work together and creates a sustainable financial community. Some time will be needed to see how this unique model works in the United States.

Strategic Considerations and Impacts

For underbanked consumers, the ability to obtain cost-effective services for small-dollar value, short-term credit needs can be quite difficult. To meet this demand the marketplace will ultimately need to broaden the suite of small-dollar, short-term credit products available. To succeed, these products need to be both fair to the consumer and profitable to the service provider.

Critical factors of the design and delivery of these services are considered below.

Product and Pathways

While the fundamentals of a small-dollar value, short-term loan product are not entirely unique, pricing and repayment involve critical subtleties. Bringing any product successfully to the underbanked market will require finding a price point that incorporates the risk profiles of the target consumers while attracting them with fair and understandable terms.

What is that right price point? Is a 36 percent APR feasible? For consumers with credit risk or lack of history, simply scaling down an existing loan product to a short-term, small-dollar value product may require more than an APR alone to manage the risk and establish a profitable business.

Rigorous business modeling and model comparisons must be executed over time to ensure that the pricing is fair, realistic given the cost and risk burden, and attractive to underbanked consumers. The ability to offer consumers a fair price can help to build a loyal customer relationship that will encourage consumers to use the bank, not alternative service providers, for other needs. It will help break a pattern that can lead away from savings and credit building.

While many consumers appear insensitive to the relatively high costs of payday loans, it is often the case that underbanked consumers have thought through their options and, given their circumstances at the time, have made the best choice available. As options increase in the marketplace, price competition will emerge. The right balance can help provide more options and better pricing.

Possibly more critical than finding a proper price point is establishing an effective repayment term. Once again, experimentation and modeling are required. Consumers need options depending upon their given needs and current economic state. Some will be able to repay at the

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next pay cycle, some within a month, and still others will require an installment loan over several months.

Once again, choice is critical—as long as it doesn't lead to debt traps for consumers and long-term, unprofitable offerings for financial service providers. More research is needed to better understand and identify what works for specific consumer types so they get the right product at the right time.

Additionally, the structure of borrowing should provide options tailored to the consumer's assets and discipline. A line of credit may work well for a disciplined consumer with sufficient assets to qualify, but for others a basic loan offering fixed payments over a set period may be better for both lender and consumer. Products that offer a line of credit with immediate repayment requirements are examples of offerings that specifically address such needs. There will no doubt be room in the market for both, but only with the proper underwriting and risk management.

Marketing and Distribution

To increase the likelihood that these consumers can be retained and potentially move up to a better product, it is important to market a small-dollar value, short-term product as an add-on feature to an existing relationship, at least initially. Without a defined path, such a product might well end up creating a new set of credit risks and significant customer churn.

The best way to define and discuss pricing will require experimentation. Certainly legal requirements around APR must be followed, but an APR description may not mean much to consumers of these loans. Consumers want to balance an immediate need with a potential cost that is easy to determine and compare.

The pricing dilemma can also increase in light of brand and reputational risk. Discussing a short-term loan in terms of 150 percent APR creates an entirely different perception than a simple fee of, say, \$12.50 per \$100 borrowed. For this type of loan, consumers may find it easier to compare a disclosed flat dollar cost. This certainly is the case when they are comparing similar product types. In contrast, however, a flat pricing disclosure does not work for longer-term credit or lines of credit, where an annualized cost is a more appropriate comparison. In addition, line-of-credit products, in which rates may change depending upon the length of the credit extension, require clear communication about rates and fees.

From a distribution standpoint, a key measure of the FDIC pilot program will be whether banks can build sufficient volume. The program has proposed that these products be gateways to enhanced banking relationships, but an unanswered question is just who is served by bank and non-bank entities. Further study is needed to further clarify consumer preferences relative to these products. These are critical factors to understand when developing the right marketing models.

Underwriting and Risk Management

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Efficient and effective risk management is necessary to make short-term, small-dollar value loans profitable. With relatively low prices, the underwriting process must be fast and effective to match consumer need as well as protect the lender. Given technological advances, the automation of manual tasks, and credit scoring, there is an opportunity to bring related efficiencies to this market. Doing so would help meet a key element of consumer demand.

Consumers facing an immediate financial crisis with minimal assets to draw upon are naturally led to services that promise immediate funds. Financial services addressing this need must offer a simple, fast application and disbursement procedures, low credit limits, and relatively short repayment schedules (generally from a single pay cycle to no more than 18 months). The ability to provide quick access to needed funds will be a defining characteristic of successful offerings.

Risk management remains critical because offering these products to any consumer would come with the potential for high defaults or charge-offs. Efficiently and effectively managing the risk profiles will aid, long-term, in reducing the overall cost of these loans.

From a credit-building perspective, a consumer using short-term credit such as a payday loan does not always see the benefits of timely repayments. Though there is nothing in the Fair Credit Reporting Act (FCRA) preventing it, such short-term loans are not typically reported as trade-line data, largely because data enters the bureau systems on 30-day cycles.

Short-term loans, often repaid within two weeks, would require more frequent reporting from lenders or development of an alternative reporting method. The alternative would need to capture loans that enter as open in one reporting period and paid in the next. To spur such a change, lenders and the credit bureaus would have to agree on the need and value for reporting and using this data.

Reporting to the bureaus would, however, aid consumers in not just building a credit history, but acting as a first step that, over time, could enable them to qualify for other credit products offered by an institution. And by reporting to the bureaus, financial providers would also be able to find out if consumers had an existing loan. This information would aid the lender in underwriting and limit the number of loans consumers could obtain from multiple providers.

A final element of risk management for the small-dollar value loan is to consider the ability to repay versus the ability to collect. In this vein, consider the prepaid card, a financial tool commonly used by the underbanked. Prepaid cards offer some potential as a vehicle for short-term, small-dollar loans, but only with certain caveats. Companies offering these products currently have some risk models for determining an appropriate credit line to extend, but it is imperfect. It will be important to offer consumers loan amounts that provide the funds needed but in such a way that the consumer can repay the loan without having to roll it over or establish another loan.

For some consumers, a short-term loan can be coupled with a savings feature. Although this can help many people build savings, it won't necessarily reduce the demand for credit products—partly because some consumers don't trust themselves to pay themselves back.

Even so, it certainly reduces the risk of these products, in turn reducing the cost basis of these services and ultimately the price to consumer.

Conclusion

The sheer size and success of the payday lending market attests to the fundamental demand for small-dollar, short-term loans. Consumers, who years ago could obtain some such services at local financial outlets, now face an array of alternative financial products, for which they are paying significantly. There is an opportunity for financial service providers that are willing to develop new operational processes and systems to recapture many of their current clients' fees.

From a product perspective, the subtlety of pricing and repayment is critical to a successful small-dollar loan product. While the proper price point for such loans has not yet become clear, it is obvious that to build demand, the products must be priced fairly, have effective and timely risk-management procedures, and be cost effective for the service provider and the consumer alike. These products must also incorporate realistic repayment schedules that help consumers establish a positive pathway to savings and away from debt. Only thus will a long-term relationship be established that will mean a more profitable customer for financial institutions.

Payday Lending Literature Review: Summary of Findings

A great deal of research has been devoted to the question of whether payday are a benefit or harm to consumers. Researchers have clearly documented that payday loan customers pay equivalent interest rates far in excess of those charged by mainstream lenders, and that many payday customers use these products frequently. Yet some researchers have noted the strong demand for payday loans and question whether high rates and frequent repeated use are indications of the need for limits to this type of credit.

This is a summary of the findings of key studies related to payday lending. A full bibliography follows.

Payday Lending Industry and Lending Terms

- King and Parish (2007), “Springing the Debt Trap: Rate caps are only proven payday lending reform.”
 - Study finds that interest rate caps are the significant way to limit payday loan repeat borrowing, more so than any other measure.
- King, Parish, and Tanik (2006), “Financial Quicksand: Payday lending sinks borrowers in debt with \$4.2 billion in predatory fees every year.”
 - Finds that borrowers with five or more advances per year constitute the vast majority of payday loan volume.
 - Finds that borrowers in all the states pay extraordinary APRs for these loans.
- Elliehausen and Lawrence (2001), “Payday Advance Credit in America: An Analysis of Customer Demand.”
 - Confirms high rates of repeat borrowing among certain segments of payday customers.
- Chessin (2005), “Borrowing from Peter to Pay Paul: A Statistical Analysis of Colorado's Deferred Deposit Loan Act.”
 - Finds high levels of repeat borrowing as well as borrowing from multiple payday lenders, despite regulators’ attempts to curb such use.
 - Examined recent data collected on payday lenders in Colorado.

Impact of Payday Lending Use and Impacts

- Morgan (2007), “Defining and Detecting Predatory Lending.”
 - Defines “predatory lending” as a financial “welfare reducing provision of credit.” In other words, a person is worse off after obtaining a particular form of credit.
 - Focuses on three groups of borrowers most at risk of being deceived into overborrowing (those with uncertain future incomes, those with low education, and those with high discount rates), and then uses data from the Survey of Consumer Finances to test whether payday lending fits the “predatory” definition.
 - Results suggest that payday lending does not fit the “predatory” definition in states that allow unlimited payday lending and that increased payday lending competition may drive loan rates and fees lower.
 - Also states that more data is required to confirm the benefit of payday loans.

- Skiba and Tobacaman (2007), “Payday Loans, Uncertainty, and Discounting: Explaining Patterns of Borrowing, Repayment, and Default.”
 - Provides some evidence that payday loan use has to do with borrowers’ lack of self-control.
 - Finds that over half of consumers of payday loans default on their loan within one year of the initial loan and that borrowers who default have repaid or utilized five payday loans by the time of default. Those who do so end up paying interest equal to 90 percent of the initial loan principal.
- Morse (2006), “Payday Lenders: Heroes or Villains?”
 - Finds that distressed communities actually benefit from payday lending. In addition, further analysis suggests that banks do not increase these borrowers’ welfare as well as payday lenders do.
 - However, Morse notes that this analysis says little about the impacts of those payday borrowers who may be tempted by payday loans to overconsume.
- Morgan and Strain (2007), “Payday Holiday: How Households Fare after Payday Credit Bans.”
 - Examines impacts to consumers of payday loans in two states before and after payday lending bans (North Carolina and Georgia). States that have not experienced a ban are used as a control group.
 - Tests financial performance using three different measures associated with payday borrowers—bounced checks, complaints about collection practices, and bankruptcy rates.
 - Finds increases in all three measures following a payday lending ban, suggesting that consumers find options in the absence of payday loans, such as bounce protection, to be poor substitutes.
 - This study has created widespread debate. The Center for Responsible Lending has published a strong critique of the study and called into question the validity of the data, research methods, and findings. A response by Morgan and Strain is included in a revised January 2008, edition of the study.

Payday Firm Behavior

- Faris and Stegman (2003), “Payday Lending: A Business Model that Encourages Chronic Borrowing.”
 - Findings show that chronic borrowing (by those who receive at least one payday loan per month) is highly predictive of payday lenders’ profit.
 - Finds the number of chronic borrowers is second only to total customer volume in predicting performance.
- Flannery and Samolyk (2005), “Payday Lending: Do the Costs Justify the Price?”
 - Findings come to a somewhat different conclusion using previously unreleased data from two large payday lenders. While findings indicate that repeat borrowing does improve profits, the authors note that this is true only insofar as repeat borrowing leads to greater loan volumes.

Payday Store Geographic Location/Concentration

- Graves and Peterson (2005), “Predatory Lending and the Military: The Law and Geography of ‘Payday’ Loans in Military Towns.”
 - Study focuses on military service members and using geographic data on lenders in 20 states that have high concentrations of military personnel or large bases. The study compares payday lender density in these areas to statewide average densities.
 - Results show substantial additional concentration of payday lenders around military populations, they conclude that lenders do indeed target military populations.
- Oron (2006), “Easy Prey: Evidence for Race and Military Related Targeting in the Distribution of Pay-Day Loan Branches in Washington State.”
 - Finds African American and military personnel populations are associated with higher payday lender concentrations in Washington state, patterns also associated with a scarcity of traditional bank branches in these neighborhoods.
- King, et al. (2006), “Financial Quicksand: Payday lending sinks borrowers in debt with \$4.2 billion in predatory fees every year.”
- Burkey and Simkins (2004), “Factors Affecting the Location of Payday Lending and Traditional Banking Services in North Carolina.”
 - Both studies confirm concentrations of payday lenders around African American populations in North Carolina.
 - The studies both find inconclusive evidence that payday lenders disproportionately locate near Hispanic populations.

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About CFSI:

The Center for Financial Services Innovation, a non-profit affiliate of ShoreBank Corporation, facilitates financial services industry efforts to serve underbanked consumers across the economic, geographic and cultural spectrum. It provides funding and resources, enables partnerships, and identifies, develops and distributes authoritative information on how to respond to the needs of the underbanked profitably and responsibly. CFSI works with banks, credit unions, technology vendors, alternative service providers, consumer advocates and policy makers to forge pioneering relationships, products and strategies that will transform industry practice and the lives of underbanked consumers. For more on CFSI, go to www.cfsinnovation.com.

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