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How Should We Serve the Short-Term Credit Needs of Low-Income Consumers?

Melissa Koide and Rachel Schneider

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Introduction

Almost one-third of the 30 million U.S. households who are unbanked or underbanked borrow to pay for small-dollar, short-term needs. They obtain loans through payday lenders, rent-to-own centers, pawn shops, refund anticipation lenders, or any of a variety of other non-mortgage–related sources, including friends and family.[1] These individuals either conduct their financial lives entirely outside of traditional banks and credit unions (unbanked) or maintain a checking or savings account while also using alternative providers (underbanked). Lower-income and certain minority groups are disproportionately represented among unbanked and underbanked households.[2]

Almost 40% of those borrowing do so to pay bills or to cover basic living expenses. Other major reasons to borrow include making up for lost income, paying for home repairs or a major purchase such as an appliance, or helping friends and family. These statistics are open to various interpretations. They suggest that some unbanked and underbanked borrowers have too little income to cover their expenses and thus require better income supports and/or budgeting guidance. The numbers also reveal a substantial need for more households to accumulate savings so they can weather disruptions in earning power or fund major purchases without taking on debt.For several reasons, however, income supports, budgeting guidance, and additional savings will not entirely fill the need that credit satisfies.

First, well-structured credit can support a household's ability to save.

It can do so directly by incorporating a savings feature into a debt product, or indirectly by providing a means to fund short-term spending without dipping into longer-term savings.

[1] According to the FDIC, 27% of the 9 million unbanked and 40% of the 21 million underbanked households in the United States borrow from alternative financial service providers, yielding a total of 10.8 million borrowers among the 30 million unbanked/ underbanked households. The FDIC also points out that its estimate of 30 million such households may be low because there are an additional 5 million banked households about whom insufficient data was gathered to determine if they are underbanked. See FDIC, National Survey of Unbanked and Underbanked Households, December 2009.

[2] Almost 54% of black households, 45% of American Indian/Alaskan households and 43% of Hispanic households are either unbanked or underbanked, versus 26% of the total population. Nearly 20% of lower-income households, those with incomes lower than $30,000 per year, are unbanked, versus 8% of the total population (FDIC National Survey).

Second, building a credit history is a critical financial asset in its own right.

Because credit scores are used by mortgage lenders, employers, insurers, landlords, and others, a positive credit history is crucial to long-term financial prosperity. Developing a sound credit history requires taking on and then paying down debt.

Third, credit can facilitate an investment or purchase that provides the foundation for other wealth-building activities.

In many cases, taking on credit can lead to financial prosperity more quickly than saving for the same investment or purchase. Home mortgages have been the traditional example of this use of credit. But this logic can be applied equally well to short-term debt that pays to fix a car so someone can get to a better-paying job, that pays medical bills that allow a person to get essential healthcare, or even to purchase a washer/dryer that frees time for childcare or education instead of visits to the laundromat.

To meet these goals, small-dollar, short-term credit must be high quality. It must be marketed transparently and priced fairly. It must be affordable and structured to support repayment—without creating a cycle of repeat borrowing or "rolling over" of the loan—and repayment must be reported to the credit bureaus. Ideally, it may also be accompanied by other features, such as savings accounts or budgeting advice that can prepare the borrower for greater financial prosperity over time. However, the additional complexity created by such features must be balanced against the convenience, speed, and privacy consumers demand and the additional costs they create for the lender.

Unfortunately, there is a shortage of high-quality small-dollar, short-term credit in the marketplace today. This gap in supply exists despite the fact that the last decade or more saw a dramatic and traumatic excess availability and overuse of credit. The gap in the supply of well-structured credit is evidenced by the fact that underbanked consumers use a great volume of payday and other expensive loans.[3] Furthermore, this gap is likely exacerbated by the current recession and the tightening of credit. Certainly some consumers who previously relied on credit card debt or overdraft protection now need to identify other means of obtaining credit, even as their need for credit may be growing because of job loss or other financial stress. This is an especially pressing issue for the millions of consumers who have seen their credit scores drop

[3] The growth and use of payday lenders is well documented. See Michael Herrman and Jennifer Tescher, "A Fundamental Need: Small-Dollar, Short-Term Credit," Center for Financial Services Innovation, 2008, for a bibliography of some of this research.

over the past two years and who not only lack a loan product to meet their credit needs, but who also lack a means to get back into the system to begin to rebuild their credit scores.

While excess credit is hardly desirable, we do need to increase access to appropriate forms and amounts of credit for all households who need it and can benefit from it.

In a previous paper, CFSI described the broad landscape of small-dollar loan providers. This paper builds on that discussion by discussing the demand for short-term credit and examining credit products that hold potential to meet that demand. It seeks to explore the challenges these products face in order to identify business strategies and public policies that can support the development of an efficient marketplace for high-quality, small-dollar, short-term credit.

Underbanked Consumer Demand for Credit

According to the FDIC's National Survey of Unbanked and Underbanked Households, released in December 2009, at least 25% of U.S. households are unbanked or underbanked. This includes 9 million unbanked households, in which no adult has a checking or savings account, and 21 million underbanked households, in which at least one adult has a bank account but the household also relies on alternative financial services.[4] To conduct this survey, the FDIC partnered with the U.S. Bureau of the Census to survey approximately 47,000 individuals in person. The survey included several questions about the use of credit products provided by payday lenders, pawn shops, rent-to-own stores, and refund anticipation loan providers. It is the largest survey on this topic, providing invaluable and authoritative data about the behavior of unbanked and underbanked households.

The FDIC found that the percentage of households who are unbanked declines sharply with increasing income, education, or age. Nearly 20% of those U.S. households earning below $30,000 per year are unbanked, versus the national estimate of 8%. The likelihood of being underbanked also declines with income, education, and age, but less markedly. For example, households with incomes between $30,000 and $50,000 are almost as likely as those with incomes under $30,000 to be underbanked.

Race and ethnicity also affect banking status. Twenty-two percent of black households, 15% of American Indian/Alaskan households, and 19% of Hispanic households are unbanked, versus 4% of Asian and 3% of white households. Similarly, minority groups more likely to be

[4] Specifically, the FDIC defines alternative financial services as non-bank money orders, non-bank check cashing services, payday loans, rent-to-own agreements, pawn shops, and refund anticipation.

underbanked include black households (32%), American Indian/Alaskan households (29%), and Hispanic households (24%), versus 7% of Asian and 15% of white households.

A significant portion of unbanked and underbanked consumers borrow. According to the FDIC, 27% of unbanked households used payday loans, entered into rent-to-own agreements, or borrowed from pawn shops within the prior year, or have taken out a refund anticipation loan within the past five years. Among underbanked households, 40% have done so.

The FDIC's findings validate the size and importance of the underbanked marketplace, and generally confirm CFSI's findings in its 2008 Underbanked Consumer Study.[5] In this study, CFSI interviewed approximately 2,800 unbanked and underbanked individuals by phone and mail. The survey included a series of questions about credit use as well, defining credit more broadly than in the FDIC survey to include not only alternative financial services providers such as payday lenders, but also friends and family, credit cards, auto loans, student loans, and other types of credit. The CFSI study also included questions about the amounts borrowed and the respondent's attitudes and preferences about borrowing.

Reading these two studies together paints a vivid picture of who is borrowing and why, how, and where they are doing so.

Who is borrowing?

CFSI's study found important behavioral and attitudinal differences between unbanked and underbanked individuals who had borrowed within the previous 12 months and those who hadn't.[6] Those who borrowed are:

More likely to be underbanked or previously banked, versus never banked.

Sixty-one percent have checking accounts currently, 27% had a checking account in the past, and only 12% have never had a checking account. This is consistent with the FDIC's finding that borrowing from alternative financial services providers is higher among those with bank accounts—related in part to the fact that a bank account is necessary to access many types of credit, including payday loans.

[5] CFSI Underbanked Consumer Study, June 2008. The CFSI study found a similar number of underbanked households in the United States (21 million) as the FDIC study, but a much larger number of unbanked households (19 million compared to the FDIC's 9 million). Some of this variation probably results from methodological differences.

[6] The FDIC has not yet released results enabling understanding of how the behaviors of borrowers differ from those of non-borrowers. These findings are expected in early 2010.

Less comfortable with banks and bank products.

For both borrowers and non-borrowers, the number-one reason reported for having no bank account was that the respondent thought he or she had too little money to make using a bank account worthwhile.[7] However, among unbanked households who have borrowed within the last year, trust issues are also apparent in their reasoning: 21% reported that they don't trust banks/credit unions or that they had had a bad experience with banks in the past, compared to 15% for the total unbanked and underbanked population. In addition, 18% said they don't know how to manage a bank/credit union account, compared to 10% for the total unbanked and underbanked population.

More likely to use the internet.

Fifty-one percent of borrowers had used the internet within the prior week, versus 35% of non-borrowers and 40% of all unbanked and underbanked respondents.

More willing to ask questions about financial matters.

More borrowers than non-borrowers said they were willing to ask household members (44% versus 35%) or banks/credit unions (37% versus 27%) about money.

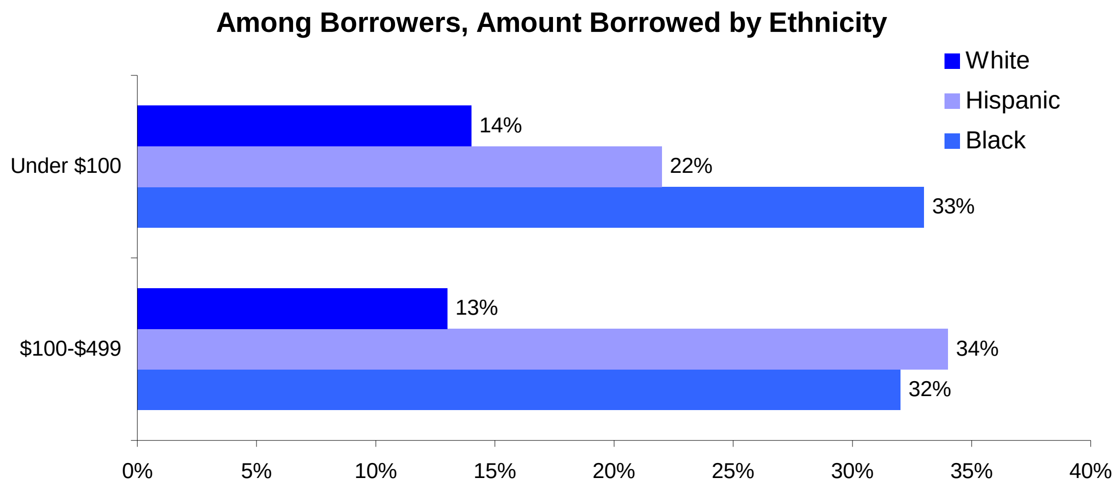
Among those who borrowed within the last 12 months, there seem to be two distinct behavioral patterns within the CFSI study respondents. One group generally borrowed once per year for larger amounts, with 83% borrowing over $1,000. Their top reason was to purchase a car or truck.

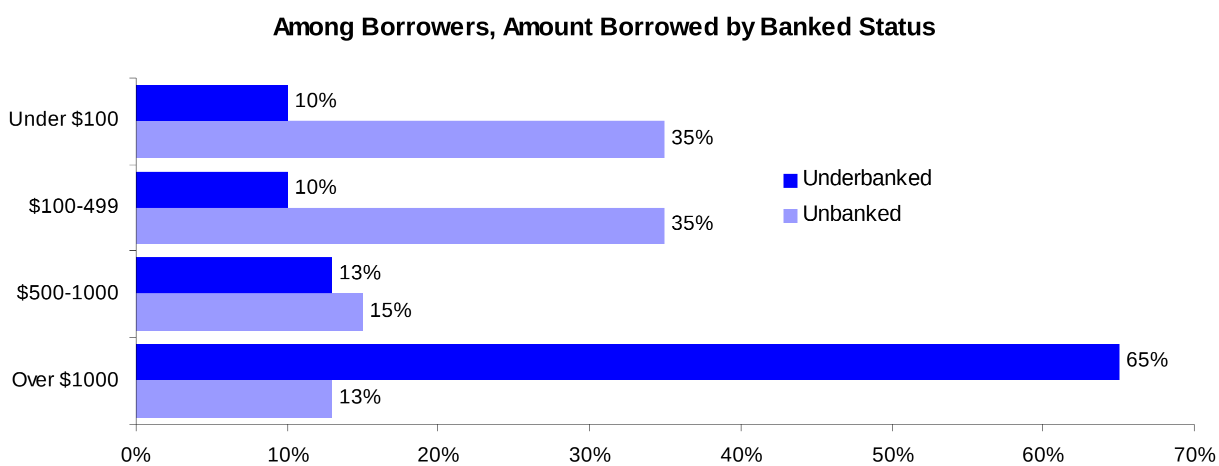
The other group of frequent borrowers generally borrowed smaller amounts—between $100 and $1,000—two to four times a year. This group relies on a wide array of debt products, including personal loans (51%), lines of credit (39%), and cash advances on credit cards (37%). Importantly, over a third of this group (36%) borrows from family and friends. They borrow to pay for utilities (32%), home repairs (31%), basic living expenses (22%), repayment of other debt (21%), or medical bills (17%).

There are meaningful differences in the borrowing behaviors of different demographic groups, with whites borrowing larger amounts than African Americans and Latinos, and older

[7] This finding was common to both the FDIC and CFSI studies.

people borrowing larger amounts than younger people. These findings correlate with the fact that underbanked individuals are more likely to borrow larger amounts than unbanked individuals, and are also more likely to be white and older. Similarly, these findings are likely connected to income, with higher-income individuals borrowing larger amounts. That said, it is worth pointing out that 38% of all unbanked and underbanked individuals with incomes between $20,000 and $30,000 reported borrowing over $1,000 the last time they borrowed.[8]





These findings suggest that market segmentation is crucial to designing loan products that meet consumer needs. Cultural differences are key, but so is variation in borrowing patterns across many other criteria. One group of borrowers needs to borrow small amounts, perhaps regularly. Another segment would benefit from larger installment loans with longer repayment

[8] CFSI.

periods. Still other segments need solutions that recognize the meaningful financial ties that borrowers have with their families and broader communities.

Why do unbanked and underbanked consumers borrow?

Both the FDIC and CFSI studies cite the need to pay bills and cover basic living expenses as the biggest reason unbanked and underbanked households borrow (38%). Other major reasons to borrow include making up for lost income (15%) or paying for home repairs or an appliance (7%).[9]

38% of unbanked and underbanked borrowing is used to pay for basic living expenses[10]

Among specific demographic groups, additional reasons to borrow emerge as particularly important.[11] For example, according to the CFSI study, 18% of Latino unbanked and underbanked households and 17% of African American unbanked and underbanked households report that they have borrowed to help friends and family, versus only 7% of white unbanked and underbanked households. Similarly, 16% of Latinos and 15% of African Americans borrowed to pay back money owed, versus 8% of whites.

Unsurprisingly, medical expenses cause more older individuals to borrow, with 16% of those between 65 and 75 and 26% of those older than 75 reporting medical bills as a reason that they have borrowed, versus 7% of the total unbanked and underbanked population. Younger people are more likely to borrow for education, with 15% of those aged18–24 citing education as a reason to have borrowed, versus 8% overall.

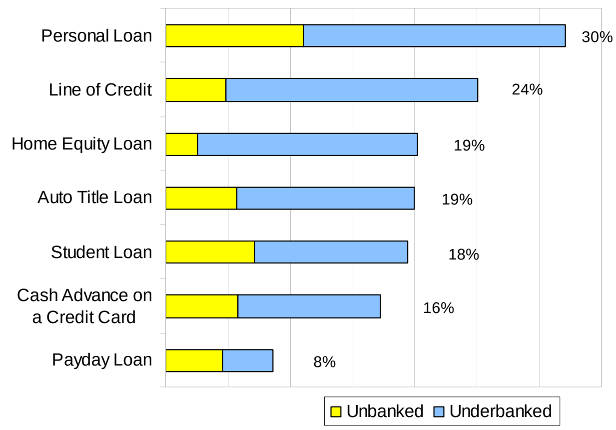
[9] FDIC. Note that 23% of respondents answered “other.” CFSI also found that auto purchases are a major reason to borrow (17%).
[10] FDIC.
[11] CFSI. These findings do not control for income.

How do unbanked and underbanked consumers borrow?

First places to turn for less than $1,000

- Bank or credit union (35.5%)
- Family member (33.6%)
- Friend (9.1%)

Types of Loans Ever Used
(# of borrowers, % represents $ of Combined Un-/Underbanked)



Unbanked and underbanked individuals borrow in a variety of ways. As the above table with data from the CFSI study shows, they use personal loans, lines of credit, home equity loans, auto title loans, credit cards, and payday loans. When asked to name the first place they'd turn for a loan of less than $1,000, however, unbanked and underbanked respondents ranked banks and credit unions (36%) and family members (34%) almost equally.

Latinos appear to borrow from friends and family even more often. Forty-two percent of Latinos would go first to a family member to borrow under $1,000, and only 23% would go first to a bank or credit union. For white borrowers, these numbers are reversed, with 42% preferring banks or credit unions and 30% saying they'd go first to a family member. Black borrowers evidence no real preference for banks or credit unions, with 33% going first to a bank or credit union for under $1,000 and 31% to a family member.[12]

The lesson from this is that lenders to the underbanked must determine how best to leverage social networks. The strength of personal networks for Latino and African American borrowers in particular cannot be ignored. There is an opportunity either to lend directly to

[12] CFSI. These findings do not control for income.

groups of borrowers, as Grameen America is doing, or to otherwise engage social networks in encouraging repayment.

In addition, providers of credit products to unbanked and underbanked households should not discount the reach of the internet. It is clearly a viable way to market to potential borrowers and to communicate with current borrowers, as evidenced by the growth of online lenders such as Prosper, Elastic, and Swish in the United States, as well as Wonga in the United Kingdom. Online and mobile models could be critical for both new and traditional providers of credit.

Early evidence indicates that customers will value credit innovations from new or nontraditional sources, such as retailers, as well as from banks and credit unions: 45% of unbanked and underbanked consumers who have borrowed in the last 12 months identify banks and credit unions as places where they would prefer to conduct financial transactions, while 38% would prefer retailers. These findings are consistent with the preferences of unbanked and underbanked households overall, regardless of borrowing behavior.

Older individuals appear to be more inclined to access banks and credit unions to meet their credit needs. Among unbanked and underbanked individuals between 18 and 24, 17% would go first to a bank or credit union, while 61% would go first to family. Among those between 55 and 64, these numbers are reversed, with 45% going first to a bank and 20% first to family.[13]

Similarly, those with higher incomes are more likely to report a preference for banks and credit unions for their borrowing needs. Forty-eight percent of individuals with household incomes between $40,000 and $50,000 say they would borrow first from a bank or credit union, while 26% would prefer to borrow first from family. For individuals with household incomes under $20,000, these numbers are 27% and 39% respectively.[14]

No group of respondents said their first choice would be a payday lender. In the CFSI study, only 2% of unbanked and underbanked individuals said they would go first to a payday lender to borrow under $1,000, although 8% of this group said they had used payday lenders. The FDIC survey uncovered even higher use of payday lenders, with 7% of unbanked and 16% of underbanked individuals estimated to have obtained a loan from a payday lender within the last year.

[13] CFSI.
[14] CFSI.

Only 2% of unbanked and underbanked individuals report that they would go first to a payday lender to borrow under $1,000.

Though the data is insufficient to explain the full range of reasons why borrowers use payday loans, it is clear that convenience and ease of application are major factors. The FDIC found that 26% of payday loan borrowers used payday lenders because of their convenience—evidence that borrowers want their credit needs to be met quickly and without application processes they perceive as onerous or intrusive.

The difficulty of qualifying for a bank loan is both a real and a perceived issue for underbanked consumers. Forty-three percent of payday loan borrowers say they use alternative credit because it is easier to qualify for a payday loan than for a bank loan.[15] This could refer to the application process, as banks generally take longer to make lending decisions than payday lenders. But it also likely references underwriting standards.

The disconnect between borrowers' stated preference for how to borrow and their actual borrowing behavior indicates a significant opportunity for alternative lenders who can provide a product that meets the same consumer needs as payday lenders but is better structured. Faster underwriting and greater transparency in underwriting are part of the solution. There may also be a role to play in this market for lending models that do not require any underwriting.

Why did you use a payday lender?[16]

Payday Borrowers

- **43%: easier to qualify for payday than for bank loan**
- **26%: payday loan place is more convenient**
- **16%: don't qualify for bank loan**
- **11%: other**
- **2%: payday loan service feels more comfortable than a bank**

Opportunities to Meet Demand in New Ways

Several key findings emerge from this analysis of the available data about borrowing behavior and preferences among unbanked and underbanked consumers. Perhaps the most important finding is that it is critical to segment the market: there is a significant diversity of

[15] FDIC.
[16] FDIC.

borrowing needs in terms of loan purposes, size, duration, and repayment structure. As a result, successful lending models must customize the product being offered for different consumer needs. The models described below each attempt to accomplish this in different ways.

Emerging Models to Supply Small-Dollar, Short-Term Credit

Despite consumers' need for access to a variety of different small-dollar, short-term loan products, there is insufficient availability of products that are profitable for the provider, yet affordable and responsibly structured.[17] The inadequate supply of high-quality small-dollar credit options appears to stem from a variety of interrelated factors, including capital constraints on lenders, perceived or real regulatory challenges for banks and credit unions, negative stigma attached to small-dollar credit providers, and underwriting methods that inadequately assess risk. These factors have contributed to an inefficient marketplace and reduced competition, resulting in limited product options and suboptimal prices for consumers.

In the discussion that follows, we examine products that hold potential for increasing the supply of high-quality small-dollar, short-term credit and explore the challenges that they face in an effort to identify business strategies and public policies that can support this expansion.

Lenders must achieve sufficient profitability, whether on a product or a customer-relationship basis, to become sustainable businesses over time. Of course, different types of institutions aim for different levels of return. Some of the lending models profiled below are motivated by social or regulatory returns as well as by financial returns. But in all cases, effectively covering costs and generating some profit is a requirement for long-term sustainability.

It is challenging for several reasons to achieve a breakeven point with small-dollar loan products that are affordable to consumers. One of the most significant is that many of the costs to offer a loan are the same whether the loan is large or small. These include processing and verifying the application, staffing and overhead expenses, underwriting, issuing the funds, processing payments, and pursuing collections. When these costs are applied against smaller loans with shorter terms, they result in higher APRs or higher fees per dollar loaned.

In addition, it is necessary to invest in technology to handle applications, underwriting, servicing, collections, and customer support. While an opportunity exists to create seamless, low-cost platforms for various delivery channels—and some platforms to do so are emerging—for

[17] For a description of the history of small-dollar credit in the United States and the market dynamics that have led to this phenomenon, see Herrman and Tescher, "A Fundamental Need: Small-Dollar, Short-Term Credit," CFSI.

now lenders must invest in developing their own customized technological solutions.

Furthermore, while in some cases it makes economic sense to develop a platform that can be used in place of high-touch personal interaction, in others, the success of the business models relies in part upon face-to-face engagement with the borrower. That personal interaction requires staff engagement as well as a costly physical presence.

Scale and lending volume are necessary for profitability. However, capital to fund operations and lending, particularly in this highly credit-constrained environment, is both scarce and expensive. The high cost of funds and constraints in the supply of capital are significant barriers to growth and sustainability, particularly for non-bank lenders.

A final, major factor limiting profitability deserves particular attention: losses stemming from high default rates. Each of the lending models profiled below has taken a different approach to managing this issue. Installment lenders establish a physical presence in the community. Some banks work with nonprofit partners to identify and counsel customers. Workplace and account advance models employ very little underwriting and instead rely on automatic payment mechanisms. The major differences in the cost drivers of various lenders stem largely from these choices.

Depository Participation in Small-Dollar Lending

Historically, banks and credit unions, along with installment lenders, have provided the bulk of small-dollar consumer credit. Banks' and credit unions' prominence in the consumer loan market, however, fell with the widespread use of credit cards and the emergence of other types of small-dollar lenders. Nevertheless, some depositories—including both banks and credit unions—have continued to make small-dollar loans to consumers. The products typically include installment loans and secured credit products, and increasingly banks and credit unions are adding savings and financial education as part of the offering. The depositories making these loans tend to be community banks or credit unions that serve primarily minorities and lower-income consumers.

For example, El Banco de Nuestra Comunidad, a division of The Peoples Bank, a Georgia-based bank focused on serving the unbanked and underbanked Hispanic market, offers a variety of credit products designed for Hispanic customers with little or no credit history. El Banco underwrites loans to these borrowers using a wide range of nontraditional credit data, including check cashing activity, money transfers, bill payments, prepaid card and bank account usage, rental history, employment verification, and length of residence in the United States.

El Banco's initial credit application requires face-to-face interaction, with significant time spent with customers, who often lack the application information and require education on the importance of maintaining a good credit history. Since El Banco started a lending program in 2006, it has lent over $13 million in consumer and credit builder installment loans, $55 million in residential mortgages, and $3.5 million in small business loans. Throughout this period, it has experienced relatively low losses and delinquencies with its loan products.

Thirty community banks are participating in a two-year small-dollar credit demonstration project initiated by the FDIC. The demonstration, which began in 2008, is designed to increase the understanding of the dynamics of depositories offering small-dollar, short-term loans with APRs of 36% or less. The 30 participating banks are providing loans in two categories: those less than $1,000 and those between $1,000 and $2,500. Over the first year, banks originated 8,346 loans of less than $1,000, with a total balance of $5.5 million. The FDIC reports that while delinquencies have been above average, actual defaults are in line with national consumer loan trends.

Although data about costs and profitability of these loans are not available, information is available that sheds light on the banks' motivations and challenges. The FDIC has found that participating banks offer small-dollar loans for three reasons: 1) to build new customer relationships and enhance existing ones, with the goal of achieving per-customer profitability over the long term; 2) to build good will with the community and fulfill Community Reinvestment Act responsibilities; or 3) to issue a profitable product in the immediate term. Of the banks that have met the goal of generating profit from the loans in the immediate term, most if not all were located in lower-income areas, where consumer demand for the loans was strong.

Many of the participating banks offer or require financial education as part of their small-dollar program. One participating bank found a strong positive correlation between the size of the loan requested and the borrowers' interest in financial education.

One-third of participating banks require their small-dollar loan customers to open savings accounts linked to the loans, and nine encourage but do not require savings accounts. By the end of the demonstration project's fourth quarter, 300 linked savings accounts had been opened, with an aggregate balance of $78,000. There appeared to be greater interest in and use of the savings accounts among borrowers who took out larger loans for longer periods, a useful insight for designing small-dollar loans that both meet consumers' needs and help to build toward longer-term financial stability.

Credit unions are also increasingly offering small-dollar loan products at some of the lowest prices in the market, in part because of guidelines established by the National Credit Union Administration, which set an 18% interest rate ceiling on loans made by credit unions. In some cases additional benefits such as automatic savings and financial education are a part of the loan package. The Pennsylvania Credit Union Association in partnership with the Pennsylvania Treasury, for example, established the Better Choice short-term installment loan, with terms of 30, 60, or 90 days and payment options of weekly, bi-weekly, or monthly. To facilitate savings, 10% above the requested loan amount is loaned and automatically deposited into a savings account for the borrower, and that money cannot be withdrawn until the loan is paid in full. The Better Choice loan is intended to break even, and losses on the loans have been relatively low, ranging between 5% and 6%. But to induce credit unions throughout the state to participate in offering the product, the Pennsylvania Treasury reimburses losses on the loans up to 50%.

Bank/Credit Union Small-Dollar Lending

Business Model Innovation/Advantages:
- Cross-subsidizes costs
- Generates a long-term customer relationship

Business Model Challenges:
- Underwriting requires access to multiple data sources
- Customer engagement can be time-intensive
- Demand varies by geographic location
- Costs of maintaining branch network

Installment Lenders

While not a new product, installment loans are receiving renewed attention as a potentially high-quality option for small-dollar, short-term credit. Installment lenders, which operate out of brick-and-mortar stores, are located predominantly in the southeastern United States, where state laws governing consumer loan products and terms are less restrictive. The installment lending industry is composed of many small, independent stores and a handful of large companies. The World Acceptance Corporation, one of the larger installment lenders, with stores in the United States and Mexico, operates 900 offices throughout the Southeast. In 2009, it loaned $1.9 billion in 1.9 million transactions, yielding an average loan size of a little over $1,000, with an average term of 11 months.[18]

Given the structure of installment loans, consumers typically borrow more money for longer terms than is the case with other small-dollar, short-term credit providers. Two types of installment loans are generally available: small unsecured loans of less than $1,000 with a term of one year, and larger secured loans, ranging between $1,000 and $5,000, with terms of one to three years. Loans are offered at fixed rates—APRs can vary from 36% for larger, longer-term loans to as high as 450% for smaller, shorter-term loans[19]—and are repaid in equal periodic installments of principal and interest, with no balloon payment at the end.

Like traditional bank lenders, installment lenders operate out of physical stores, and they assess the borrower's creditworthiness before deciding whether to make a loan and at what price. Installment lenders usually examine the borrower's credit report and score, although that information is not the sole factor in the lending decision. Other considerations include the borrower's job tenure, employment history, monthly income and expenses, and ability and willingness to repay the loan.

In some cases, the installment lender develops its own credit assessment system, which can enhance its ability to qualify consumers with thin or no credit histories. Progreso Financiero, a relatively new and growing installment lender with 23 locations in California, uses a proprietary underwriting system modeled after small-dollar lenders in Latin America. The company, which provides lower-income Latinos with short-term installment loans, has made almost 40,000 loans with its underwriting tool.

Once the installment loan is made, repayment history is reported to the major credit bureaus and becomes part of the borrower's credit record. Thus, installment loans, unlike many other small-dollar, short-term credit products, enable consumers to build or repair their credit scores.

Because consumers must deliberately decide to apply for installment loans, some planning and intentionality is required of borrowers. The fact that installment loans are offered at

[18] World Acceptance Corporation, Annual Report, 2009, http://www.worldacceptance.com/annual_report.php.
[19] It is worth noting that installment loans were explicitly excluded from the 2006 Talent Amendment, which effectively barred payday lenders from operating in close proximity to military bases by capping the rate that could be charged at 36%.

a fixed rate and are paid back in equal payments may help to ensure that the loan remains an affordable part of a consumer’s budget.

Installment loan companies typically locate stores in the communities in which they operate. Lenders report that this interaction helps to assess the borrower’s financial situation and keeps them abreast of any potential challenges the borrower may have in repaying the loan. Lenders consider their direct interaction with consumers and physical presence in the community as critical to controlling default rates.

Because of the high-touch aspects of this model, installment loans are costly to provide. The primary cost drivers of the installment lending model arise from the operation of physical stores and from underwriting expenses, including credit checks and bank fees. One industry representative estimates that achieving breakeven on a $200 loan requires charging borrowers an APR of about 250%. The breakeven APR drops to approximately 145% if the volume of $250 loans reaches 1,000. Larger loans in the amount of $2,500 would require APRs closer to 44%, and the breakeven APR would drop to a projected 35% if 1,000 loans at that amount were made.

Although the installment lending industry has been around for decades, the difficulty of finding adequate capital keeps many lenders from scaling up, which would enable increased profitability and reduced prices. Raising necessary capital from banks and other lenders has long presented challenges, given the stigma attached to the small-dollar, short-term loan industry. That challenge has intensified amid the general credit constraints of today’s economy.

Installment Lending

Business Model Innovation/Advantages:

- Larger loans and longer terms
- Fixed rates/equal repayments
- Loan data reported and accepted by major credit bureaus
- Application decision and direct interaction may facilitate responsible borrowing

Business Model Challenges:

- High APR
- Difficulty of securing capital for stability, growth, and expansion
- Costs of bricks-and-mortar model

Account Advance

A handful of large banks offer "salary advance" or "account-advance" products, whereby a checking account holder with direct deposit into his account can access short-term, small-dollar lines of credit. The account holder requests the advance, and can do so in increments of as little as $20 and up to a maximum of $500. The fee charged for these products is generally $2 for every $20 borrowed, resulting in an APR of 120%. The advance is automatically repaid from the next direct deposit into the account, and the entire amount must be repaid within 35 days. Banks generally impose restrictions on the access to the account-advance products following consecutive use of the product for 9 to 12 months. Banks also often include materials in the marketing of advance products explaining that the products are costly and advising consumers to explore other sources of low-cost credit.

An analogous product is the Meta iAdvance loan, which is offered by Metabank, a federal savings institution with a division that specializes in payment products, including prepaid cards and credit cards. With the iAdvance loan, the advance is authorized and repaid based on direct deposit to a prepaid card rather than a checking account. The consumer applies online or by phone, and the loan is made and becomes available in a matter of minutes. The fee is $2.50 for every $20 advanced, resulting in an APR of 150%. Meta also limits access to the advance feature for borrowers who have accessed it in more than 12 consecutive months.

Rather than being triggered by the simple act of overdrawing one's account, these products require the borrower to apply for the funds. While they have higher APRs than many other forms of bank credit, they carry substantially lower APRs than typical payday loans. They can also cost less than overdraft, especially for consumers who overdraft small amounts. According to Bankrate.com, the average fee charged for courtesy overdraft is $29.

Account advance lines of credit do not require the kinds of application process or extensive underwriting that credit cards or typical bank installment loans require. Customers may apply for the account advance, or the bank may solicit them following an assessment of a customer's cash flow and tenure with the bank. From the bank's perspective, there is no application to review or verify, no underwriting expenses, no paperwork or processing costs. From the account holder's perspective, there is no application to complete, little concern about acceptance, and no waiting. Once the credit is available, it can be withdrawn from the ATM.

Because this streamlined process dramatically lowers the bank's cost of offering credit, the bank can afford to offer credit in much smaller increments while still managing costs. In the case of iAdvance, Meta's operating costs are lowered even further because it does not need to support a branch network or a physical presence. An initial technology investment is necessary to build the product platform, but most of the product delivery is then automated, leading to variable costs that are likely much lower than those of traditional lenders or payday lenders.

In addition, some account-advance lenders limit their default-related losses by offering initial loans in amounts as small as $20. Thus, even though default rates on these first loans can be quite high, total losses can be manageable. As the lender sees positive repayment patterns emerge, the amount of credit available to a borrower can be increased.

Criticisms of the account-advance products currently on the market are that the repayment period is short—generally one pay cycle—which is often too little time for the borrower to amass the funds to repay the loan, and that there is repeat usage of the product leading to high total costs. The fact that borrowers can access such low amounts may help to mitigate this problem for many, because they borrow only what is necessary.

Account Advance Products

Business Model Innovation/Advantages:

- Streamlines application, disbursement, and repayment options
- Eliminates underwriting, with manageable impact on default losses

Business Model Challenges:

- Requires initial investment in technology: systems development to facilitate loan requests, disbursement, and repayment
- Capital requirements: high-risk nature of the loans leads to a high cost of funds or high reserve requirement
- High acceptance rate leads to high default rates

Workplace Lending

The workplace may represent an important channel for reaching underbanked consumers with a wide variety of financial products and services because of its advantages in scale, facilitation, and timing. Financial services companies gain access to a large potential customer base by catering to a company's workforce. The infrastructure of the workplace facilitates the distribution of financial services. Meanwhile, employees enjoy the convenience of making decisions about their saving and spending in the context of when and how they receive their earnings.[20]

Using the workplace to provide small-dollar loans can reduce the costs of the loans in two ways. First, the use of email and other workplace communication systems can significantly cut marketing costs. And second, direct access to the payroll system can help to offset underwriting costs and facilitate repayment.

Two companies, eDuction and DFM, have designed small-dollar loan platforms that use the payroll system to authenticate the potential borrower for the loan, determine the appropriate loan amount and cost, and facilitate repayment through automatic payroll deduction, thus significantly reducing delinquencies and defaults.

Another workplace model involves credit unions partnering with local employers to provide small-dollar, short-term loans; in some cases, these partnerships have been brokered by community organizations. The United Way of Chittenden, Vermont, for example, facilitates partnerships between local credit unions and a number of small and midsized employers to offer loans. The credit products offered typically consist of installment loans that must be repaid before a subsequent loan can be taken out. The borrowing employee must be in good standing with the employer. Automatic payroll deduction is used to facilitate repayment, and the loans are offered at an APR of 18%. At the end of the loan tenure, instead of closing out the automatic payroll process, employees are offered the option of continuing the wage deduction, with the money deposited into a savings account—something installment lenders could not do without a bank partner. Approximately half of participating employees have opted to use the automatic savings option. Of the 184 loans that were made in the program so far, 10 borrowers have defaulted.

The state of Virginia is piloting a workplace loan program for state employees in conjunction with the Virginia Credit Union. Six months after it was launched, the program had lent almost $1.4 million. Loans are available from $100 to $5,000, in increments of $100. Employees have up to six months to repay the loan in full, and no more than two loans can be taken out in a calendar year. The APR, regardless of loan amount or term, is fixed at 24.99%. Direct deposit is used to facilitate repayment from a Virginia Credit Union account. The employee must be a credit union member and must complete an online financial education module. Data is not available on the profitability or losses on these loans.

[20] See Sarah Berke and Rachel Schneider, "Employer-Based Collaboration: Lessons from Financially Fit Minnesota." Center for Financial Services Innovation, 2009, for further discussion of this idea.

The workplace small-dollar loan approach can offer a simple, automated enrollment and payment process to access the loan. The use of automatic payroll deduction should reduce the administrative costs and the likelihood of delinquencies and defaults. Lenders report they value the opportunity to strengthen their relationships with employers. And the use of automation can facilitate additional features such as savings and personalized financial education messaging.

Workplace Lending

Business Model Innovation/Advantages:

- Reduces marketing and administrative costs
- Low to no defaults via automatic repayments through payroll debits
- Benefits employers as well as employees
- Opportunity to add savings/education components

Business Model Challenges:

- Obtaining capital for loans
- Risk of repayment may be prioritized over consumer necessities
- Underbanked may not be employed by employers offering workplace loans
- Cost to establish and maintain an effective partnership could be substantial

Encouraging Variety of Models in the Marketplace

Each of these models, in its own way, addresses part of the demand for credit among unbanked and underbanked consumers. But the fact remains that there is still a significant gap between the demand for affordable short-term, small-dollar credit and the supply. The models described face significant challenges to scale, which inhibits their ability to continue to improve their products for consumers' benefit. While some of these challenges can be solved in the marketplace, there are also some potential systemic or public policy solutions that could help resolve some of the common challenges to expanding and attaining scale, ensuring that underbanked individuals have access to credit products.

Table 1. *Summary of Loan Types Discussed and Relative Expenses*

	Salary Advance	Depositories	Installment Lending	Workplace Lending
Provider Examples	Wells Fargo, US Bank, Fifth Third, MetaBank	El Banco FDIC Small-Dollar Pilot Depositories Credit Unions	Highly fragmented industry	Virginia State Employee Loan Program, United Way of Chittenden County
Loan Amount (Approximate)	Up to $500	Tranches of $1,000 or less or $1,000 or more	Up to $5,000 or more	Varies—Up to $500
Stated APR	120%–150%	16%—36%	Varies	$\leq$ 36% (Requires financial institution participation)
Repayment Term	Up to a month (Repaid with succeeding direct deposit)	Biweekly; Monthly; Multiple Years	Up to three years	Up to one year
Underwriting Criteria	Account with direct deposit	Varies May include credit check, budget analysis, proof of income)	Varies (May include credit check, budget analysis, proof of income)	Must be an employee in "good standing"
Relative Expenses				
Upfront Costs (customer acquisition, application processing, underwriting)	Low (Highly automated process with very limited underwriting)	Varies (May include standard underwriting along with in-person assessment and use of nontraditional data)	High (In-person underwriting process with little automation)	Medium (Limited underwriting cost, but requires synchronized processing procedures)
Servicing and Customer Support	Low/Medium (Automated repayment)	Varies (Depending upon the customer targeted, servicing and support ranges from medium to high)	High (Maintenance of physical outlets, in-person payments)	Medium (Automated repayment, but loans serviced at traditional financial institutions)
Cost of Funds	Dependent on funding source	Varies	High (Typically sourced through syndicates; seen as "high risk")	Low (Loans funded by partnering financial institution)
Credit Losses	High	Medium	High (Dependent on underwriting, but can reach the mid-teens)	Low (Limited by payroll repayment; defaults typically occur only in cases of severance)
Primary Cost Driver	Infrastructure investment	Customer support	Upfront costs (In part because of physical outlet)	Costs to manage a partnership

Small-Dollar Lending Challenges and Potential Solutions[21]

Three major challenges are discussed below: 1) the lack of generally accepted criteria to define high-quality credit products; 2) the insufficient availability of capital to support lending and the growth of small-dollar lenders; and 3) the high operating costs inherent in the business model.

Challenge: Lack of Common Product Definition

Potential Solution: Create Loan Standards

In addition to meeting the requirements for consumer acceptance and struggling for profitability, innovative lenders must develop credit products that are structured to help borrowers achieve their short-term goals and improve their financial prosperity over the longer term. There is increasing agreement about what responsible lending like this might mean. Certainly, high-quality small-dollar, short-term credit must be transparently marketed and fairly priced. It must be affordable and structured to support repayment—without creating a cycle of repeat borrowing or "rolling over" of the loan—and repayment must be reported to the credit bureaus. However, the specific definition of each of these criteria, and prioritization if they cannot all be achieved equally, are still hotly contested.

Furthermore, some argue that high-quality loans should also be accompanied by other features, such as saving accounts or budgeting advice, that are designed to enable borrowers to achieve greater financial prosperity over time. These features increase complexity for both the lender and the borrower, and so must be balanced against cost concerns and the convenience, speed, and privacy that consumers demand.

The lack of consensus around defining responsible loans creates several real challenges for lenders. Because it increases the reputational risks of offering these types of products, it decreases the number of potential entrants into the marketplace. This makes price competition, which would be positive for borrowers, less likely. It also makes it more difficult for small-dollar lenders to access capital. Fewer lenders make capital available to small-dollar, short-term loan providers because they are concerned about reputational risk themselves.

Common metrics about the best ways to structure small-dollar, short-term loans could provide a foundation for many other possible solutions to the challenges faced by new entrants into this market. They could aid in the creation of policies and regulations related to small-dollar,

[21] A number of these solutions are being explored as part of a CFSI-Pew Charitable Trusts Working Group on Small Dollar Lending.

short-term lending, while providing the financial services industry with clarity and direction. Such metrics would need to take into account the need for diversity in the marketplace, allowing for revolving credit as well as installment loans of varying size and duration. They would ideally be designed as guideposts, in order to allow for new product developments and market changes.

These metrics could be encouraged via public policy, with policymakers defining the criteria—as opposed to explicit definitions—for safe loan products by establishing minimum qualifications for "good" small-dollar, short-term credit. Such criteria could be used for assessing loans under consumer protection rules and as a means for determining eligibility for government incentives that encourage lenders to offer high- quality products. In designing its loan pilot, the FDIC has taken a step toward articulating such qualifications, but policymakers could do more to engage industry, advocates, and other stakeholders in formulating criteria for a greater diversity of loan products offered by both bank and alternative financial service providers.

At the same time, the industry could establish such metrics for itself. Lenders are beginning to establish the knowledge and infrastructure needed to identify some industry guidelines for high-quality products, which may benefit both consumers and providers in setting out clear terms and thresholds for what constitutes high-quality small-dollar products and services.

Challenge: Need for Capital

Potential Solutions: Form a Loan Loss Reserve Fund and Clarify Bank Capital Requirements

Adequate access to capital is necessary for achieving scale and reaching sustainability while offering products at affordable prices. Non-bank lenders' ability to raise the necessary capital from banks and other lenders has long presented challenges, given the stigma attached to the small-dollar loan industry and the relative risk associated with the loans. That challenge has intensified amid the general credit constraints of today's economy.

To the extent that available capital is scarce because of the potential risks of such loans, lenders could take advantage of several ways to ensure the availability of additional capital for innovative, responsible lenders. Options might include facilitating the development of a secondary market for small-dollar loans (which would likely require some common definitions of high-quality small-dollar loans) or the formation of a loan fund enabling investors to pool their investment dollars and diversify their exposure to multiple types of loans. Alternatively, public policy could facilitate the formation of a loan loss reserve fund.

The capital challenge facing depositories is one that pertains to the regulatory oversight of capital reserves, and there, policymakers could provide greater clarity and consistency around the capital requirements for depositories making small-dollar loans.

Form a Loan Loss Reserve Fund

One public policy option to increase the availability of capital to alternative small-dollar lenders could be the creation of a loan loss reserve fund, which qualified firms could tap to offset a portion of the costs associated with making small-dollar loans to underserved consumers. The fund's primary purpose would be to enable small-dollar lenders to acquire more capital to grow their businesses and offer more affordable loans. Over time, participating lenders would achieve sufficient scale to operate independently of the loan loss reserve fund. To help ensure that participating firms will ultimately reach and maintain sustainability, only firms that are adequately capitalized would be eligible to use the fund. And to encourage firms to make prudent loans, the fund would be structured to reward firms that keep losses low; those with lower losses would be eligible for higher reimbursement rates.

Such a program could improve the availability of small-dollar credit to underserved consumers in several ways. By helping to offset a portion of the costs to provide credit, it could expand the number of loan providers in the marketplace and the amount of credit available to consumers. It could induce larger financial institutions to extend credit to small-dollar lenders. And, if it were created by the federal government, it could bring valuable attention and legitimacy to the small-dollar credit needs of low-income and financially underserved consumers.

Such a program could also enable the federal government to target programs to build consumers' financial capability at a financially relevant point by requiring or encouraging lenders to provide financial information when the loan is made.

Clarify Capital Requirements for Depository Institutions

Regulatory attention could also help to address a frequently noted impediment—whether real or perceived—cited by depository institutions wishing to provide small-dollar loans by clarifying the capital requirements for depository institutions making such loans.

As a general regulatory rule, banks are required to maintain levels of capital that are commensurate with the risk associated with their loan portfolios. Increased regulatory scrutiny and higher capital requirements are required when total subprime loans are greater than 25% of an institution's Tier I capital. Very few banks, however, reach this threshold in short-term, small-dollar lending. Nevertheless, in this economic environment, regulators are paying significant attention to higher-risk loans in general, and banks are reporting that regulators are imposing greater scrutiny on these loans even when the loans are not at the threshold, which serves as a disincentive for offering these loans.

As a policy matter, both depositories and regulators who are concerned with promoting access and ensuring safety and soundness would benefit from an analysis of the risk of carrying a small portfolio of small-dollar loans. The insights from the analysis could offer greater clarity for industry and regulators on useful techniques for managing risk, ensuring compliance, and reporting effectively. While no one wants to see these types of products put the depository institution at risk, regulatory attention and clarity regarding whether and what requirements are needed to guard against risk for loans that are less than 25% of Tier I capital would aid banks seeking to provide small-dollar loans.

Challenge: High Operating Costs

Potential Solutions: Encourage Partnerships and Technology Investments

High operating costs for small-dollar lenders must be lowered if lenders are to sustainably offer small-dollar loans to borrowers. There are several routes to reducing costs, and smart market solutions and public policies can facilitate their growth and development. First, partnerships among lenders, nonprofits, and employers can shift the business model of the lender in crucial ways. Second, the development of streamlined delivery and processing platforms could improve the economics for a wide variety of small-dollar lenders.

Encourage Partnerships among Lenders, Nonprofits, and Employers

By partnering with nonprofits and/or employers, lenders can leverage the trust, infrastructure, and physical presence of those institutions. This can create substantial benefits for lenders and consumers alike. For lenders, advantages to this model include lower marketing costs, streamlined loan processing and lower default rates. Benefits for borrowers include lower prices, faster application processes, and the ease of accessing credit in locations and environments that are convenient and comfortable for them.

The federal government could help to promote the benefits of such partnerships to employers and their employees by examining existing workplace loan programs and seeding new workplace loan demonstrations that would yield deeper insights into employees' demand for small-dollar loans. In addition, the government could develop policies that encourage employers to provide small-dollar loan options to employees and that induce lenders to partner with employers. Tax incentives to employers for providing small-dollar loan programs, for example, or the targeted use of the loan loss reserve fund described above, could expand the availability of small-dollar loans through the workplace.

Streamline Technology Systems

Minimizing the cost of lending requires significant technological infrastructure. By reducing the cost of application, underwriting, servicing, and customer support processes, technology solutions can help make small-dollar lending viable at lower prices. Opportunity clearly exists to create seamless, low-cost platforms for various delivery channels that would meet consumer needs and make products sustainable.

Without standard platforms, lenders must develop customized technological solutions. Lenders should explore ways to work together to maximize the utility of this type of investment. Credit unions in particular have been effective at creating service bureaus or co-operatives through which they share back-office costs. These could provide relevant models for coordination. Given the strong consumer demand for small-dollar loan products and the changing dynamics of this part of the consumer credit industry, technology vendors should also be looking closely at this opportunity.

Conclusion

Although unbanked and underbanked consumers clearly need better access to small-dollar, short-term credit, meeting those needs is challenging, as the descriptions of the loan products above attest. However, there is considerable opportunity to offer small-dollar, short-term credit products that meet consumers' needs, are responsibly structured, and offer the promise of profitability for the lender. An encouraging variety of business models is emerging, including credit products offered by traditional financial institutions and new entrants.

Lenders are balancing significant trade-offs in the design of these credit products. In designing their business models, some lenders choose to support fairly intensive interactions with their borrowers—whether created through physical locations or partnerships with community organizations—while others offer automated, more distant connections. Lenders either invest in manual underwriting that takes into account detailed information about the borrower and a wide range of alternative data sources—or they simply evaluate whether or not direct deposit cash flow is sufficient to support repayment. Lenders also offer a range of credit products, including revolving credit and installment loans of all sizes.

These choices result in substantially different cost structures. Additional information about the underlying economics of these businesses and the riskiness of the loans they offer is needed to more deeply understand the extent to which the variation in cost structures explains the wide variation in APRs evidenced in the marketplace. This deeper understanding of the economics of supply is critical to informing public debate about the appropriate use and structure of credit. It is also baseline information that will enable the development of appropriate public policy interventions to support the growth of an efficient small-dollar loan marketplace.

A related point is that more information is needed to understand the relative merits and impact on consumers of the loan products available today. This would help policymakers and others to invest their resources in advancing types of credit that are most beneficial for consumers.

Still more innovation is necessary to fully meet consumers' needs. Nonetheless, because there is meaningful diversity among the credit needs of the almost 10 million unbanked and underbanked consumers who borrow, the diversity of the emerging business models is positive for consumers.

Fostering access to a range of high-quality credit products offered through many different, attractive, convenient channels will help to narrow the current gap between demand and supply, enabling individual borrowers to access the type and amount of credit they need when they need it.

About CFSI:

The Center for Financial Services Innovation is the nation's leading authority on financial services for underbanked consumers. Since 2004, its programs have focused on informing, connecting, and investing—gathering enhanced intelligence, brokering and supporting productive industry relationships, and fostering best-in-class products and strategies. A nonprofit affiliate of ShoreBank Corporation, CFSI works with leaders and innovators in the business, government, and nonprofit sectors to transform the financial services landscape. For more on CFSI, go to www.cfsinnovation.com.