

# SMALL-DOLLAR LENDING INNOVATION AND THE TRUE COST OF CREDIT

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# INTRODUCTION

Small-dollar lending is a critical part of the economy and one of the solutions to helping address scarcity in credit, especially for the 80% of Americans who reportedly continue to live paycheck-to-paycheck.<sup>1</sup> These are loans that are generally obtained to meet the short-term needs of consumers who often do not have access to conventional loans.

Such loans can come with a relatively high fixed cost. But for years, industry observers and opponents of small-dollar lending have attempted to measure these costs with the annual rates used for calculating the cost of home and car loans. These measures, however, are not appropriate ones to use for short-term products. They tend to lead to confusion for potential borrowers and limit the availability of credit for those who need it, mostly low- and middle-income individuals.

<sup>1</sup> Emmie Martin, "The Government Shutdown Spotlights a Bigger Issue: 78% of US Workers Live Paycheck to Paycheck" (CNBC, Jan. 9, 2019), <https://perma.cc/9P47-KKX6>.

## THE NEED FOR SMALL-DOLLAR CREDIT

The Center for Financial Services Innovation undertook a study in 2017 of consumers of financial services who were underserved. It found that 67 million consumers face a barrier to borrowing due to low incomes and the same is true for 54 million Americans due to income volatility. Approximately 91 million consumers have subprime credit scores or insufficient information about their credit history to obtain a loan. These people have difficulty obtaining conventional loans but are served by what is known as the small-dollar credit market.<sup>2</sup>

<sup>2</sup> Eric Wilson and Eva Wolkowitz, "2017 Financially Underserved Market Size Study" (Center for Financial Services Innovation, Dec. 2017), <https://perma.cc/95S2-MYAH>.

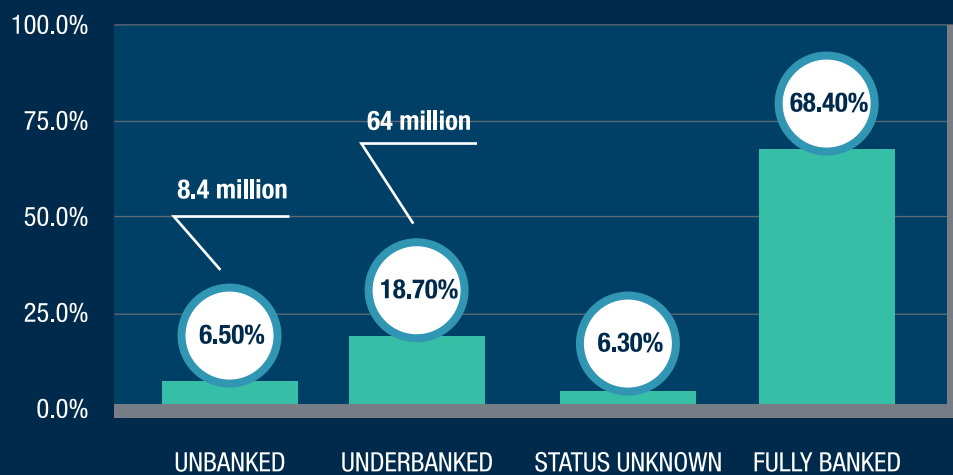
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CFSI estimates that about 15 million people use SDC products annually. These products include payday, auto title and pawn loans, plus deposit advance and installment loans of under \$5,000.<sup>3</sup> According to the U.S. Office of the Comptroller of the Currency, \$90 billion is borrowed annually through short-term loans, ranging in size from \$500 to \$3,000 per loan.<sup>4</sup> Although the size of the loans are relatively small, the size of this market is not, and for good reason.

Since 2009, the Federal Deposit Insurance Corporation has conducted a biennial survey of consumers in order to determine their financial status and to identify barriers to financial inclusion. The most recent survey collected responses of 35,000 households. It found that 6.5% of U.S. households, representing 20 million people, had no checking or savings account in a bank — a group that is known as “the unbanked.” An additional 18.7% of households, or about 64 million people, are considered “underbanked,” that is, they have an account at a bank, but used financial services outside of the mainstream banking system.<sup>5</sup>

### FDIC FINANCIAL STATUS SURVEY 2017



<sup>3</sup> “Small Dollar Credit” (Financial Health Network, 2019), <https://perma.cc/B7XU-6XG8>.

<sup>4</sup> “Core Lending Principles for Short-Term, Small-Dollar Installment Lending” (Office of the Comptroller of the Currency, May 23, 2018), <https://perma.cc/E2GR-R6XV>.

<sup>5</sup> “FDIC National Survey of Unbanked and Underbanked Households” (Federal Deposit Insurance Corporation, Oct. 2018), 1, <https://perma.cc/RXH5-7NTE>.

As might be expected, these surveys have consistently found that financial products that are available to the unbanked and underbanked populations are more expensive. Providers of these services take a large financial risk to lend money to this population and must include the cost of this risk in the pricing.

This practice is known as “risk-based pricing.” As an example, the FDIC surveys found that low-income, less-educated and younger households as well as households with volatile incomes are typically charged more for these products. These are also households that, due to their historically high risk of default, find it difficult or impossible to borrow through more conventional channels provided by banks and credit unions.

<sup>6</sup> “Report on the Economic Well-Being of U.S. Households in 2017” (Board of Governors of the Federal Reserve System, May 2018), 2, <https://perma.cc/4WZ9-JEXD>.

<sup>7</sup> Adrian D. Garcia, “Survey: Most Americans Wouldn’t Cover a \$1K Emergency with Savings” (Bankrate, Jan. 16, 2019), <https://perma.cc/V753-YA4E>.

The financial struggles of this segment of the population is well-documented. The Federal Reserve found in a recent survey that 40% of adults could not cover an unexpected expense of \$400 without selling something. Over one-fifth of adults reported they are not able to pay all of their current month’s bills in full.<sup>6</sup> The January 2019 Bankrate’s Financial Security Index reported that only 40% of Americans could meet an unexpected \$1,000 expense through savings.<sup>7</sup> These statistics suggest that there is a large need for small-dollar, short-term lending.

## EVOLUTION OF SMALL-DOLLAR LENDING

In the 1980s, storefront loan businesses that provided small-dollar credit without the need for collateral or a credit score began to emerge. Typically, these businesses were offering short-term products, commonly called payday loans. Payday loans are normally of duration of less than one month and are for amounts less than \$500. To get the loan, borrowers provide the lender a check for the amount borrowed plus the cost of a fee, but this check is dated for when the loan is due. The loan may be extended and only the fees paid.

<sup>8</sup> “Payday Loans: Time for Review” (Federal Reserve Bank of St. Louis, Oct. 1, 2014), <https://perma.cc/WX9U-D9SW>.

The Federal Reserve Bank of St. Louis estimated that in 2014 there were approximately 20,000 storefront lenders of this type.<sup>8</sup> While this may seem like a large number, the storefront industry was not able to keep up with the demand for small-dollar, short-term financial products.

In the last 10 to 15 years, borrowers have increasingly been able to obtain small-dollar loans through online lenders, corresponding to a decline in brick-and-mortar payday lending. The Center for Financial Services Innovation found that payday loan volumes fell by 18% between 2014 and 2017. The number of storefronts that closed in the first nine months of 2016 exceeded 500.<sup>9</sup> Some of this shift was due to regulatory action and some to increased competition from online financial entities that are easier to access, provide a larger array of financial products and charge competitive borrowing costs.

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In 2008, the FDIC experimented with the banking system’s ability to serve the SDC market through a 24-month program known as the Small-Dollar Loan Pilot Program. The program was designed to “illustrate how banks can profitably offer affordable small-dollar loans as an alternative to high-cost credit products such as payday loans and fee-based overdraft programs.”<sup>10</sup> Under the pilot program, banks could offer small-dollar loans up to a 36% interest rate cap. This cap was imposed largely as a result of political pressure based on a view that identified “predatory lending” as anything above this arbitrary rate cap.

In short, the program failed. After two years of experience, it was clear that banks were reluctant to enter the SDC market because the 36% interest rate cap rendered these risky loans unprofitable.<sup>11</sup>

More recently, the Office of the Comptroller of the Currency has recognized this need for SDC products and released a bulletin encouraging national banks and federal credit unions to engage in short-term, small-dollar lending. The OCC also in October of 2017 rescinded a 2013 bulletin that constrained

<sup>9</sup> “Payday Lending Is Declining,” *The Economist*, April 8, 2017, <https://perma.cc/3HSX-QKKJ>.

<sup>10</sup> “A Template for Success: The FDIC’s Small-Dollar Loan Pilot Program Introduction,” *FDIC Quarterly* 4, no. 2 (2010), <https://perma.cc/PZY9-8C7R>.

<sup>11</sup> *Ibid.*, 32.

the ability of banks to make SDC products available.<sup>12</sup> These actions by the OCC may encourage more banks to enter the SDC market. However, as these loans are expensive and risky to administer, it is still not clear that the OCC actions will result in a flood of competition into the market by mainstream financial institutions. Further action may be needed.

The SDC industry is highly regulated, primarily at the state level. Eighteen states either expressly disallow payday loans or establish annual percentage rate caps on loans that, given the risks and costs of serving these types of loans, make it impossible for businesses to cover the expense of offering these products.<sup>13</sup>

Despite the fact that no matter where they live, people who have a short-term need for credit and who cannot obtain a loan will be severely hampered, it is still difficult for financial institutions and the fintech industry to provide loans across state lines due to myriad regulations. A mechanism that would make it easier for fintech companies in particular to provide SDC on a short-term basis across state lines would allow greater spreading of risk and greater competition, which would increase the availability of credit to those with the greatest need and lower the cost of borrowing.

<sup>12</sup> “Core Lending Principles for Short-Term, Small-Dollar Installment Lending” (Office of the Comptroller of the Currency, May 23, 2018), <https://perma.cc/E2GR-R6XV>.

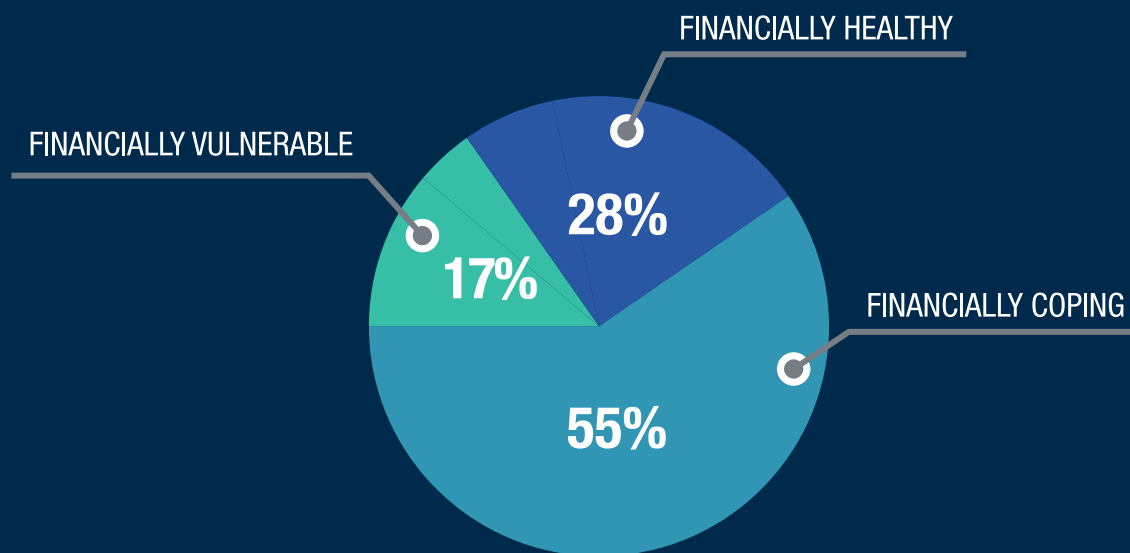
<sup>13</sup> “Legal Status of Payday Loans by State” (Consumer Federation of America, 2019), <https://perma.cc/5SZV-ARHJ>.

## FUTURE OF SMALL-DOLLAR CREDIT

<sup>14</sup> Todd H. Baker, “FinTech Alternatives to Short-Term Small-Dollar Credit: Helping Low-Income Working Families Escape the High-Cost Lending Trap” (Harvard Kennedy School, May 2017), 3, <https://perma.cc/C33U-SLNL>.

In recent years there has been substantial development in the ability of fintech to meet the needs of households unable to cover their expenses. A recent paper from the Harvard Kennedy School “concludes that private sector adoption of a set of FinTech-centered alternatives to [short-term, small-dollar credit] has the potential to shift a significant fraction of low-income working families away from reliance on the current STSDC system over time and to materially improve their financial resiliency and health without the need for government financial support or new laws and regulations.”<sup>14</sup>

One question is whether the government should restrict the ability of consumers to obtain loans of small amounts over short periods. As noted above, a substantial number of households have difficulty meeting unexpected expenses of less than \$1,000, and a significant number are either unbanked or underbanked. The Center for Financial Services Innovation estimates that 17% of Americans are what they consider “financially vulnerable,” while 55% are “financially coping,” with only 28% being “financially healthy.” Twenty-seven percent of Americans do not have prime credit scores, restricting their ability to borrow from commercial banks and savings and loans.<sup>15</sup>



One argument for restricting access to small-dollar credit services is that people are not able to make the correct decision and should not be borrowing in the first place. Even if this were true, the data clearly show that a significant number of people may need to borrow to handle unexpected expenses. Cutting them off from the ability to borrow will not improve their financial situation. In fact, it will just make it worse.

A second, more cogent, argument along these lines is that lenders should be more transparent in the terms of small-dollar credit so borrowers know what they are agreeing to. Indeed, most of these subprime consumers are repeat borrowers who become savvy about the financial products available to them. Given the fact that the risk of lending to these consumers is reflected in the loan price, the necessity of regulations to “protect” the borrower may not be significant.

<sup>15</sup> Thea Garon et al., “U.S. Financial Health Pulse: 2018 Baseline Survey Results” (Financial Health Network, 2018), <https://perma.cc/F8FE-X6TZ>.

<sup>16</sup> Ronald Mann, “Assessing the Optimism of Payday Loan Borrowers,” *Supreme Court Economic Review* 21, no. 1 (2014): 105–132, <https://perma.cc/EYK5-2QE7>.

<sup>17</sup> *Ibid.*, 109.

<sup>18</sup> Norbert J. Michel, “Payday Loans: No Need to Go Postal” (The Heritage Foundation, May 9, 2018), <https://perma.cc/ZPH6-CJ65>.

For example, a study by Ronald Mann in *The Supreme Court Economic Review* journal found that 60% of payday loan borrowers can predict how long it will take them to extinguish their payday loan.<sup>16</sup> Mann’s research showed that “most borrowers finally repay their loans and are free of debt within two weeks of the date they predicted on the date of the loan.”<sup>17</sup> Customer satisfaction also scores high with these products. A Heritage Foundation study notes that complaints of payday loan customers amounted to less than one-tenth of 1% per year.<sup>18</sup>

## RATES AND COST COMPARISONS

Credit companies may move credit across state lines. This is due to a 1978 U.S. Supreme Court case, *Marquette National Bank v. First of Omaha Corporation*.<sup>19</sup> The thrust of this case was that credit card issuers could charge whatever interest rate was allowed in the state in which the issuer was headquartered. With new financial technology allowing firms to provide access to SDC across state lines, it would be sensible to enact a similar rule for financial institutions.

Annual percentage rate is the measure often used to regulate the rate of interest that SDC issuers may charge. The APR represents the actual rate of interest someone pays over the course of a year due to compounding, the process whereby interest is added to unpaid principal. Typically, SDC customers do not borrow for a full year, and the interest charges do not compound. Use of APR for regulation and transparency does not make sense when looking at loans of small amounts and short duration.

Under the Truth in Lending Act, lenders who provide large-sized loans for home and autos, like small-dollar lenders, are also required to provide an annualized percentage rate to their products.<sup>20</sup> But these are loans that are meant to be for a lengthy duration and have low fixed cost relative to the size of the loan. It may be useful for a home or auto loan borrowers to know

<sup>19</sup> *Marquette Nat Bank v First of Omaha Corp*, 439 U.S. 299 (1978).

<sup>20</sup> 12 CFR § 1026.18(e).



APR in order to compare loan offers. However, for small loans that will have a high fixed cost to loan amount, and which are not intended to last for years, APR is simply misleading. Knowing that a loan of \$100 for one week will require a fee of \$10 is useful. Knowing that the loan has an APR in excess of 520% is not useful at all. In fact, it is more likely to confuse the typical SDC borrower than enlighten him or her.

Use of APR for SDC products also acts as a deterrent for innovation in providing access to loans for the unbanked and underbanked. First, it makes such credit seem predatory to those who have never been in a situation where they needed credit and could not obtain it. Certainly, for the average person whose borrowing needs have only included 30-year mortgages and five-year car loans, an APR of 120% seems extraordinary. In reality, SDC lenders provide a way to resolve short term financial distress for their customers.

While subprime consumers are generally savvy about financial products, using APR is an ineffective way to provide these consumers with information about the true cost of their loan. The APR measurement is also used by industry opponents who assert that loan rates are predatory, preying on the needs of the unfortunate. In response, so-called “consumer groups” have proposed an arbitrary usury cap of 36%. At this rate, as previous experience demonstrates, lenders could not cover the cost of administering the loan.<sup>21</sup>

<sup>21</sup> Thomas W. Miller Jr. and Chad Reese, “Why a 36% Cap Is Too Low for Small-Dollar Loans” (American Banker, Aug. 4, 2015), <https://perma.cc/RV7R-AVVE>.

Many people think that \$50 is too high a cost just to access \$500 before someone’s next payday. But from the perspective of the unbanked and underbanked, this might be a pretty good deal, especially if not having that \$500 today will result in ramifications or liabilities that exceed \$50 in value. SDC products do have relatively high fees, but these are caused by the relatively high risk associated with lending money to individuals with subprime credit scores.

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# CONCLUSION

There is little doubt that the need for short-term loans for small-dollar amounts is substantial. Millions of Americans are in financial situations where any small emergency may require them to obtain credit. Public policy currently limits the availability of such credit. In particular, the use of APR as a measure of the cost of credit casts the SDC community as predatory, when in fact it is serving a need that the standard financial community is unable or unlikely to meet.

Competition among lenders and innovation in mechanisms to provide SDC products are keys to keeping the cost of borrowing as low as possible for the financially stressed. Regulatory reform that expands the ability of lenders to service the low-income community's temporary borrowing needs will help alleviate their economic distress.

It is clear that the financial services industry would benefit from developing and adopting an alternative measure that provides the borrower with clear, comparative cost information that will help them make an informed choice about both the proper product and provider. Federal policymakers should work with the SDC industry to expand competition by removing barriers to entry into the market and create incentives for innovation in order to further decrease the cost of credit and facilitate more affordable borrowing for mainstream American families.

## ABOUT THE AUTHOR:

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The author is President of Hillsdale Policy Group, Ltd, and the William E. Simon Professor of Economics and Public Policy and the Director of Economics at Hillsdale College. He is the author of *A Capitalist Manifesto: Understanding Market Economy and Defending Liberty*, and has published numerous works on public policy issues. He has served in several policy positions, including Michigan's Deputy State Treasurer, member of the Michigan State Board of Education, President of the Board of Trustees of Lake Superior State University and Congressman Nick Smith's Washington Chief-of-Staff. Dr. Wolfram received his Ph.D. in Economics from the University of California at Berkeley and has also taught at the University of California at Davis, Mount Holyoke College, Washington State University, and the University of Michigan at Dearborn.