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January 18, 2019

Robert E. Feldman  
Executive Secretary  
Attn: Comments, Federal Deposit Insurance Corporation  
550 17<sup>th</sup> St NW, Washington, DC 20429

**RE: RIN 3064-ZA04 (Request for Information on Small-Dollar Lending)**

Chairman McWilliams:

Thank you for undertaking this effort to make affordable, bank-issued, small installment loans available to the millions of American families who could benefit from them. For too long, many bank customers have been unable to meet one of their core financial needs inside banks—borrowing small sums of cash. This financial exclusion has played a major role in creating a large, high-cost, nonbank loan market that includes products like payday, auto title, rent-to-own, pawn, and other subprime loans. Consumers spend several hundred billion dollars each decade on fees and interest for these loans,<sup>1</sup> even though all payday loan customers have a checking account,<sup>2</sup> and most other borrowers are also banked.<sup>3</sup>

Pew's research has found that if banks entered the small-loan market, they would have large comparative advantages over nonbank lenders, with their lower costs of doing business allowing them to offer loans profitably to many of the same borrowers at prices six times lower than those of payday and other similar lenders.<sup>4</sup> Banks would be lending in a largely automated fashion to known customers who already make regular deposits, so acquisition and automated underwriting costs would be much lower than those of nonbank lenders. The cost of capital for banks is quite low, and their overhead costs are spread among the multiple products they sell. Small installment loans would expand banks'

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<sup>1</sup> Center for Financial Services Innovation, "Sizing the Financially Underserved Market" (2017), <https://cfsinnovation.org/research/sizing-the-financially-underserved-market/>.

<sup>2</sup> The Pew Charitable Trusts, "Payday Lending in America: Policy Solutions" (2013), 4, <https://www.pewtrusts.org/en/research-and-analysis/reports/2013/10/29/payday-lending-in-america-policy-solutions>.

<sup>3</sup> Federal Deposit Insurance Corporation, "2017 FDIC National Survey of Unbanked and Underbanked Households," <https://www.fdic.gov/householdsurvey/>.

<sup>4</sup> The Pew Charitable Trusts, "Standards Needed for Safe Small Installment Loans from Banks, Credit Unions" (2018), 5, <https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2018/02/standards-needed-for-safe-small-installment-loans-from-banks-credit-unions>.

relationships with customers who until now have gone outside of the supervised and well-regulated banking system to borrow, and they may improve customer retention as well.<sup>5</sup>

Payday loans carry APRs of typically 300-500 percent, generally come due in just two weeks, and consume an average of one-third of a borrower's next paycheck.<sup>6</sup> When some banks issued deposit advances, they generally carried APRs of 200-300 percent and were due in just two weeks, which consumed an average of 27 percent of a borrower's next paycheck.<sup>7</sup> Both products have excessive prices, unreasonably short terms, and unaffordable payments. Banks can and should offer better terms than these—including fair prices, affordable installment payments, and reasonable time to repay—and the FDIC should encourage them to do so.

For banks to succeed in the small-loan market, they will need to recognize and adapt to its unique characteristics, including designing credit that works for those in financial distress. Consumers seeking small sums have very low credit scores and poor options. They focus on speed, ease of application, and certainty of approval, rather than the terms that will affect their longer-term financial health—price and affordability.<sup>8</sup> As a result, lenders compete on these factors rather than on price or affordability.<sup>9</sup> With proper guidelines from regulators, banks can compete with payday and other nonbank lenders on speed, ease, and certainty, and use the inherent advantages of diversified mainstream financial institutions to offer affordable payments and substantially lower prices. Supporting the growth of safe small installment loans from depository institutions would help keep people from leaving their banks to borrow money in the lightly regulated, costly, and inefficient nonbank sector.

As New York University's Tim Ogden has noted, "small-dollar lending has always been the bane of the banking system."<sup>10</sup> When banks did begin offering small loans at scale briefly, it was in the harmful form of deposit advance. Bank regulators were right to be seriously concerned about deposit advance, but the answer to the problems with that product is to fix them, not to push struggling consumers out of the banking system when they wish to borrow. Based on nearly eight years of research, including extensive empirical research and modeling of bank small-dollar loans, and more than 100 conversations with bank and credit union executives, Pew has developed standards for safe, small installment loans from banks

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<sup>5</sup> Neil F. Hall, *American Banker*, "Banks Should Lead the Way to More Small-Dollar Loans" (2016), <https://www.americanbanker.com/opinion/banks-should-lead-the-way-to-more-small-dollar-loans>.

<sup>6</sup> The Pew Charitable Trusts, "Payday Lending in America: Policy Solutions" (2013), 31, <https://www.pewtrusts.org/en/research-and-analysis/reports/2013/10/29/payday-lending-in-america-policy-solutions>.

<sup>7</sup> Consumer Financial Protection Bureau, "Payday Loans and Deposit Advance Products: A White Paper of Initial Data Findings" (2013), 27-29, <https://www.consumerfinance.gov/data-research/research-reports/white-paper-on-payday-loans-and-deposit-advance-products/>.

<sup>8</sup> The Pew Charitable Trusts, "Standards Needed for Safe Small Installment Loans from Banks, Credit Unions" (2018), 5, <https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2018/02/standards-needed-for-safe-small-installment-loans-from-banks-credit-unions>.

<sup>9</sup> The Pew Charitable Trusts, "How State Rate Limits Affect Payday Loan Prices" (2014), <https://www.pewtrusts.org/en/research-and-analysis/fact-sheets/2014/04/10/how-state-rate-limits-affect-payday-loan-prices>.

<sup>10</sup> Tim Ogden, Financial Access Initiative, Small Dollar Financial Services, August 31, 2018.

and credit unions.<sup>11</sup> They are as follows (see figure below):



Source: The Pew Charitable Trusts (2018)<sup>12</sup>

We are pleased that the first mass-market affordable small-dollar credit—U.S. Bank's Simple Loan, launched in September— met most of these criteria, including setting payments at 5 percent of income and pricing loans in the range Pew had identified as mutually sustainable for banks and customers.<sup>13</sup> U.S. Bank's extensive pilot prior to rolling out the product found that the payments and pricing Pew recommended were viable for the bank and customers. Pew's research has found consumers fare better

<sup>11</sup> The Pew Charitable Trusts, "Standards Needed for Safe Small Installment Loans from Banks, Credit Unions" (2018), 8, <https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2018/02/standards-needed-for-safe-small-installment-loans-from-banks-credit-unions>.

<sup>12</sup> The Pew Charitable Trusts, "Standards Needed for Safe Small Installment Loans from Banks, Credit Unions" (2018), <https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2018/02/standards-needed-for-safe-small-installment-loans-from-banks-credit-unions>. Also attached as Appendix A.

<sup>13</sup> For more discussion of the U.S. Bank announcement, see Bourke, Nick, "Momentum is Building for Small-Dollar Loans" (Sept. 12, 2018), <https://www.pewtrusts.org/en/about/news-room/opinion/2018/09/12/momentum-is-building-for-small-dollar-loans>. Also attached as Appendix B.

when the charges they pay are based on the length of the loan (such as a monthly or daily cost), rather than one flat, upfront fee,<sup>14</sup> as U.S. Bank is charging. But the core elements of this first large-scale bank installment loan program are largely sound, and they provide a useful template for the FDIC to consider as it studies this issue.

Pew's standards also help establish the balance necessary for bank small-dollar lending to benefit both customers and providers. If banks set payments that are too large, as with deposit advance, customers will suffer. But if banks are unable to serve customers with a high debt-to-income ratio or low credit score, this type of lending will not be the bulk of those who use high-cost loans today. If APRs inclusive of fees are required to be below 36 percent, programs will either not be profitable or will not reach customers who need help.<sup>15</sup> But APRs higher than 100 percent are unnecessary for bank small-dollar loans to be profitable, and excessive pricing can harm customers' financial health.

Answers to each of the questions in the request for information follow, as well as several relevant pieces Pew has published. Thank you again for undertaking this essential work on behalf of the millions of American families who have been harmed by their inability to access affordable installment credit from their banks.

### **Consumer Demand**

#### **1. To what extent is there an unmet consumer demand for small-dollar credit products offered by banks?**

Millions of Americans, approximately three-quarters of whom hold accounts at banks or credit unions, use alternative financial services annually. Pew's research has found that roughly 12 million Americans use payday loans each year,<sup>16</sup> while 2.5 million use auto title loans,<sup>17</sup> 10 million use non-depository traditional installment loans,<sup>18</sup> and millions more use other forms of high-cost small credit including

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<sup>14</sup> The Pew Charitable Trusts, "State Laws Put Installment Loan Borrowers at Risk" (2018), 23-27, <https://www.pewtrusts.org/en/research-and-analysis/reports/2018/10/17/state-laws-put-installment-loan-borrowers-at-risk>.

<sup>15</sup> The Pew Charitable Trusts, comment letter on the NCUA's Notice of Proposed Rulemaking on the Payday Alternative Loan Program RIN 3133-AE84 (August 3, 2018), 6-8, <https://www.ncua.gov/files/comment-letters/2018/comment-pal-20180803NBourke.pdf>.

<sup>16</sup> The Pew Charitable Trusts, "Payday Lending in America: Who Borrows, Where They Borrow, and Why" (2012), 4, <https://www.pewtrusts.org/en/research-and-analysis/reports/2012/07/19/who-borrows-where-they-borrow-and-why>.

<sup>17</sup> The Pew Charitable Trusts, "Auto Title Loans: Market Practices and Borrowers' Experiences, 1, <https://www.pewtrusts.org/en/research-and-analysis/reports/2015/03/auto-title-loans>.

<sup>18</sup> The Pew Charitable Trusts, "State Laws Put Installment Loan Borrowers at Risk" (2018), 1, <https://www.pewtrusts.org/en/research-and-analysis/reports/2018/10/17/state-laws-put-installment-loan-borrowers-at-risk>.

pawn, rent-to-own, and subprime purchase money loans.<sup>19</sup> When banks offered deposit advance—a harmful, single-payment loan with an APR that usually exceeded 200 percent—approximately 15 percent of eligible checking account customers used it.<sup>20</sup> All of these figures suggest not just that there is a demand for small-dollar credit, but that consumers are so motivated to borrow that millions of them accept the very high prices charged by payday and other non-depository lenders. By and large, people who use those products are seeking small amounts of cash to meet a certain need (often, paying a bill) and they typically require several months to pay it off.<sup>21</sup> Banks could offer a compelling, more affordable alternative. Payday loan borrowers strongly favor enabling banks to offer small installment loans: 95 percent of borrowers believe it would be an improvement to the status quo if regulators enabled “banks and credit unions to offer small loans at prices six times lower than payday lenders.”<sup>22</sup>

## **2. To what extent do banks currently offer small-dollar credit products to meet consumer demand?**

Most banks offer overdraft penalty services as a matter of course. Pew has found that the median penalty fee charged is \$35 per overdraft.<sup>23</sup> The Consumer Financial Protection Bureau found that 5 percent of checking account holders overdraft at least 20 times per year, implying spending of \$700 or more.<sup>24</sup> This group had FICO scores averaging 563 and very little liquidity left on credit cards if they had any. In short, they look a great deal like payday loan borrowers.

Pew surveyed customers who overdraft their checking accounts, and 32 percent reported they view overdraft primarily as a way to borrow money.<sup>25</sup> Those who overdraft regularly are using it as a form of credit. Most of them would be better off with actual small-dollar credit, such as a small installment loan from their bank.

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<sup>19</sup> Non-bank credit sources are widely available throughout the country. Payday loan stores exist in two-thirds of states, non-bank installment loan stores operate in 44 states, and both pawn and rent-to-own stores operate in every state. See Question 3 below for more information.

<sup>20</sup> Consumer Financial Protection Bureau, “Payday Loans and Deposit Advance Products: A White Paper of Initial Data Findings” (2013), 26, <https://www.consumerfinance.gov/data-research/research-reports/white-paper-on-payday-loans-and-deposit-advance-products/>.

<sup>21</sup> The fact that payday loans are generally structured as short-term advances due in two weeks belies the fact that most borrowers cannot afford the lump-sum payment and therefore pay a fee to extend the loan another two weeks, and another two weeks, and so on. The payday lender’s access to the borrower’s checking account enables this cycle.

<sup>22</sup> In Pew’s analysis, banks and credit unions could offer small loans with prices six times lower than payday lenders while still being profitable, if loan origination and maintenance were automated. The U.S. Bank Simple Loan product (discussed below) is widely available to borrowers with damaged credit histories and carries pricing at the low end of Pew’s forecasted range.

<sup>23</sup> The Pew Charitable Trusts, “Overdraft Does Not Meet the Needs of Most Consumers” (2017), 1, <https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/12/overdraft-does-not-meet-the-needs-of-most-consumers>.

<sup>24</sup> Consumer Financial Protection Bureau, “Data Point: Frequent Overdrafters” (2017), 16, <https://www.consumerfinance.gov/data-research/research-reports/cfpb-data-point-frequent-overdrafters/>.

<sup>25</sup> The Pew Charitable Trusts, “Overdraft Does Not Meet the Needs of Most Consumers” (2017), 8, <https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/12/overdraft-does-not-meet-the-needs-of-most-consumers>.

Large banks generally do not offer small-dollar loans to customers with damaged or thin credit files, though U.S. Bank is a notable exception.<sup>26</sup> Community banks sometimes offer such loans, but only on an ad hoc basis to known customers, not via a large-scale, automated program. Therefore, banks are not meeting their customers' demand for small credit. Their liquidity lending is generally available only to prime and near-prime customers via credit cards, home equity loans, and other prime products. This failure to serve their customers who could most benefit from small loans is understandable given regulatory uncertainty about offering competitively designed and transparently priced credit to customers with damaged credit histories, but it has done serious harm to tens of millions of struggling American households.

Banks' credit card offerings also generally do not meet payday loan borrowers' needs. Both conventional and subprime credit cards generally require credit scores that are higher than payday loan borrowers' scores. Secured credit cards offer a way of raising credit scores, but they typically do not offer immediate liquidity because they require funds to secure the cards' credit lines. Some payday loan borrowers reported to Pew in focus groups that they have struggled with credit cards and so instead prefer a closed-end option that will not keep them in long-term debt.<sup>27</sup>

### **3. To what extent and in what ways do entities outside the banking sector currently satisfy the consumer demand for small-dollar credit products?**

The lack of small loans available from banks and credit unions has given rise to a large non-depository small-loan industry. The roughly two-thirds of the payday loan market that operates via storefronts has about 16,000 locations in 34 states. The average payday loan customer takes a \$375 loan, has it out for five months of the year before extinguishing the debt, and pays \$520 in fees alone. The loans usually come due in just two weeks, and the loan plus fee consume an average of 36 percent of a borrower's next paycheck. Most borrowers cannot afford to sacrifice such a large share of their income, so they keep the loan for another pay period, and another. This explains why 80 percent of payday loans are taken out within two weeks of a previous payday loan.<sup>28</sup> These payments are unaffordable, so payday lenders rely on their ability to collect from borrowers' checking accounts on the borrowers' next payday.

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<sup>26</sup> Nick Bourke, *American Banker*, "Momentum is Building for Small-Dollar Loans" (2018). Fifth Third Bank is also notable for being the only bank that we have seen promoting a deposit advance product, known as Early Access. Unlike U.S. Bank's Simple Loan or other loan or credit offerings, deposit advance products do not allow for paying down debt over time. For example, Early Access advances are due in full out of the customer's next deposit(s) or within 45 days (see "Terms and Conditions" and "Frequently Asked Questions," <https://www.53.com/content/fifth-third/en/personal-banking/bank/early-access.html>, accessed on December 26, 2018). Consequently, deposit advance does not provide credit in a conventional sense. In Pew's analysis, short-term deposit advance products do not address the consumer need at the heart of the FDIC's inquiry, i.e., the ability to borrow small amounts of cash that a customer can use now and pay back over time.

<sup>27</sup> The Pew Charitable Trusts, "Payday Lending in America: How Borrowers Choose and Repay Payday Loans" (2013), 30-31, <https://www.pewtrusts.org/en/research-and-analysis/reports/2013/02/19/how-borrowers-choose-and-repay-payday-loans>.

<sup>28</sup> Consumer Financial Protection Bureau, "Data Point: Payday Lending" (2014), <https://www.consumerfinance.gov/about-us/newsroom/cfpb-finds-four-out-of-five-payday-loans-are-rolled-over-or-renewed/>.

This dynamic explains why the two requirements to get a payday loan are income and a checking account.

Similarly, auto title loans rely on lenders holding borrowers' car titles as loan security to compel repayment. Auto title loans are larger, averaging \$1,000, and the average borrower pays \$1,200 in fees alone to keep this loan out for about five months of the year. There are 8,000 storefronts in 23 states issuing auto title loans.

The pawn industry offers loans secured by collateral worth more than the loan amount. Pawn loans are smaller, averaging about \$120, and they are offered in all 50 states.

The rent-to-own industry operates in all 50 states, selling goods at prices that are typically several times more than the mainstream retail price. In this way, consumers who do not have the money to buy goods from conventional retailers or the means to borrow the money on a credit card or otherwise can make installment payments over extended periods of time. If consumers make all the payments, they own the item. If not, they can return it or the rent-to-own provider can repossess it.

Borrowing \$400 for 3 months	
Typical payday loan	\$360
Typical auto title loan	\$300
Paying 8 overdraft fees (\$35)	\$280
Typical pawn loan	\$240
Typical Deposit Advance (discontinued)	\$240
New bank small-dollar loan	\$48-\$60

Source: Pew analysis.

#### **4. What data, information, or other factors should the FDIC consider in assessing the consumer demand for small-dollar credit products?**

All of the loans described in the previous question are quite expensive with effective APRs that are usually several hundred percent. Approximately three-quarters of consumers who use alternative financial services are banked (including all payday loan borrowers).



But these consumers generally have low credit scores, so they do not qualify for conventional credit from banks. Instead, they meet their credit needs outside of the banking system at high costs, or they overdraft their checking accounts, or both.<sup>29</sup>

Pew's research has found that 81 percent of payday loan borrowers report they would switch to using bank-issued small loans if they were available to payday loan borrowers. When told the estimated pricing for such bank loans, that figure increased to 90 percent. Unsurprisingly, 93 percent of payday loan borrowers said it would be a good thing if "banks and credit unions would begin offering small loans at prices 6 times lower than payday lenders."<sup>30</sup>

Consumers are already demonstrating there is a strong demand for small-dollar credit by borrowing at exorbitant prices. Unfortunately, the products available to them are deeply harmful to their financial health because of their unaffordable payments and high costs. As discussed above and in Questions 12 and 15, below, nonbank lenders compete on factors that matter most to consumers in this market—speed, convenience, and relative certainty of approval—but regulators can and should help create the conditions in which banks can compete successfully on these factors as well while also providing loans with affordable payments and substantially lower pricing.

### **Benefits and Risks**

#### **5. What are the potential benefits and risks to banks associated with offering responsible, prudently underwritten small-dollar credit products?**

The potential benefits to banks of offering affordable small installment loans are large. Banks' cost structures are such that these loans can be profitable at prices six to eight times lower than average payday loan prices. Thus, banks would have a profitable new product line that both the public and payday loan borrowers view as quite fair. Uptake would be high, and the additional revenue would replace spending that is primarily taking place outside of banks, enabling banks to extend their relationships with their checking account customers who have not previously qualified for bank credit.

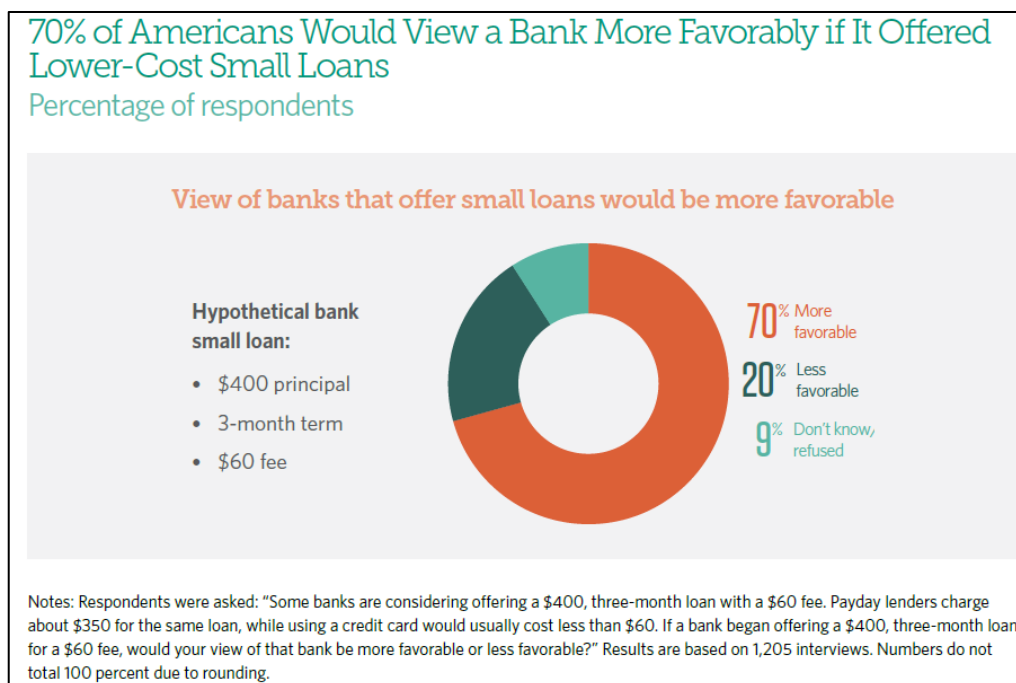
Banks also would likely improve customer retention, as several bank and credit union executives that have had small-dollar loan programs reported in conversations with Pew. Banks would also be viewed more favorably by customers and the public if they offered affordable small installment loans at fair (double-digit APR) prices (see figure below).

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<sup>29</sup> The Pew Charitable Trusts, "Payday Lending in America: How Borrowers Choose and Repay Payday Loans" (2013), 32-35, <https://www.pewtrusts.org/en/research-and-analysis/reports/2013/02/19/how-borrowers-choose-and-repay-payday-loans>.

<sup>30</sup> The Pew Charitable Trusts, "Payday Loan Customers Want More Protections, Access to Lower-Cost Credit From Banks," (2017), 8, <https://www.pewtrusts.org/~media/assets/2017/04/payday-loan-customers-want-more-protections>.





Source: The Pew Charitable Trusts (2017)<sup>31</sup>

Lastly, bank customers who use payday loans today are at risk of losing their checking accounts because payday lenders withdraw unaffordable payments, triggering overdraft fees and putting the checking accounts at risk of being closed for excessive negative balances.

In sum the benefits to banks of offering affordable small installment loans are as follows:

- 1) Additional revenue and profitability from a new product line
- 2) Expanded customer relationship
- 3) Improved customer retention
- 4) Reduction in losing customers whose accounts are closed in connection with a payday loan
- 5) Improved reputation with borrowers and the public

## **6. What are the potential benefits and risks to consumers associated with bank-offered small-dollar credit products?**

Customers stand to benefit substantially from bank-offered small installment loans. At appropriate price levels, meaning double-digit APRs that decline as loan sizes increase, consumers will save large amounts of money compared with costly nonbank products such as payday loans, auto title loans, and pawn or rent-to-own arrangements. For customers who pay overdraft fees as a way to borrow small sums (as opposed to using it as an occasional convenience), they would similarly save large amounts of money.

<sup>31</sup> The Pew Charitable Trusts, "Americans Want Payday Loan Reform, Support Lower-Cost Bank Loans" (2017), <https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/04/americans-want-payday-loan-reform-support-lower-cost-bank-loans>. Also attached as Appendix C.

Consumers who suffer financial hardships such as automobile repossession, eviction, or utility disconnection because of an inability to obtain an affordable small loan, would also save large amounts of money. Pew has estimated that these savings would exceed \$10 billion annually—surpassing the value of major anti-poverty programs such as Temporary Assistance for Needy Families Basic Assistance (TANF, \$7.4 billion)<sup>32</sup> and the supplemental nutrition program for Women, Infants, and Children (WIC, \$5.9 billion).<sup>33</sup> The primary risk to consumers would be if they borrow money out of temptation when they otherwise would be fine without borrowing. Available evidence from payday loan borrowers suggests however that there is little borrowing for temptation goods or special occasions.<sup>34</sup> Because consumers would be affirmatively choosing to take out a small installment loan, there is no risk of accidentally borrowing in the way that consumers can accidentally borrow by overdrafting their account or depositing “live check” loans from consumer finance companies.

However, customers would be at great risk if banks began offering high-cost, balloon-payment deposit advances.<sup>35</sup> When deposit advances were offered, they consumed an average of 27 percent of a customer’s next deposit, far more than most consumers can afford. They also carried prices that were most commonly 10 percent per pay period outstanding, with effective APRs frequently between 200 and 300 percent. Unaffordable balloon payments on these loans triggered additional borrowing, with borrowers using loans for eight pay periods per year at the median. The heaviest usage group took single-payment loans during 19 separate pay periods, more than two-thirds of the year.<sup>36</sup> Further, because deposit advances required unaffordable payments, it’s not clear that they were a viable substitute for costly nonbank credit. Payments on rent-to-own purchases and pawn loans are generally much smaller than payments were on deposit advances. The short terms on deposit advances (a median of just 12 days)<sup>37</sup> also made them unsuitable for credit bureau reporting because credit bureaus do not factor repayment of single-payment loans into credit scores.

Payday loan borrowers also strongly favor loans being repayable in installments rather than in a lump sum on their next payday. That is not to say payday loan borrowers will not use harmful deposit advance loans if those are what is available to them, but they almost universally recognized two weeks is not

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<sup>32</sup> Center on Budget and Policy Priorities, “How States Use Funds Under the TANF Block Grant” (2018), <https://www.cbpp.org/research/family-income-support/how-states-use-funds-under-the-tanf-block-grant>.

<sup>33</sup> United States Department of Agriculture, “WIC Funding and Program Data” (2018), <https://www.fns.usda.gov/wic/wic-funding-and-program-data>.

<sup>34</sup> The Pew Charitable Trusts, “Payday Lending in America: Who Borrows, Where They Borrow, and Why” (2012), 14, <https://www.pewtrusts.org/en/research-and-analysis/reports/2012/07/19/who-borrows-where-they-borrow-and-why>.

<sup>35</sup> While a handful of banks offered deposit advances in the early part of this decade, availability of this product shrank quickly following the issuance of the OCC and FDIC’s guidance.

<sup>36</sup> Consumer Financial Protection Bureau, “Payday Loans and Deposit Advance Products: A White Paper of Initial Data Findings” (2013), 27-37, <https://www.consumerfinance.gov/data-research/research-reports/white-paper-on-payday-loans-and-deposit-advance-products/>.

<sup>37</sup> Consumer Financial Protection Bureau, “Payday Loans and Deposit Advance Products: A White Paper of Initial Data Findings” (2013), 28, <https://www.consumerfinance.gov/data-research/research-reports/white-paper-on-payday-loans-and-deposit-advance-products/>.

long enough to repay: 92 percent believed it would be a good thing if they “would be allowed several months to repay in smaller installments rather than having loans due back in two weeks.”<sup>38</sup>

## **7. What are the key ways that banks offering small-dollar loan products should manage or mitigate risks for banks and risks for consumers?**

To mitigate risk of loss, it is likely that banks will only initially lend to their own customers who have a track record with the bank. For example, U.S. Bank is only making its Simple Loan available to customers who have had a checking account open for at least six months and have had direct deposit for at least three months. While these standards are cautious, they are prudent for a new product available to customers with low credit scores. Banks will also manage risk by using underwriting standards that can be adjusted based on their lending and repayment experience. It is likely that banks will encourage customers to set up automated plans that deduct required installment payments from customer checking accounts, possibly timed to the customer’s direct deposit schedule, or their typical manual deposit schedule. Banks may also initially choose to limit these loans to small amounts, such as \$1,000 or less, or for short terms, such as a few months. With time, as banks gain experience with small installment lending, it will likely benefit both banks and their customers if somewhat larger loan sizes with somewhat longer terms are made available.

To manage risks for consumers, loans should be repayable in affordable installments over time. Pew recommends limiting monthly installment payments to 5 percent of gross monthly income. This shields 95 percent of the customer’s income, which is a simple and powerful consumer protection especially in cases where banks automatically deduct loan payments from customer checking accounts. Extensive research demonstrates that payments in this range are affordable for most customers and suitable for lenders.<sup>39</sup> U.S. Bank has also set payments at this level. Some consumers may show signs of being unable to handle any credit, such as their inability to maintain an account in good standing. Noncredit solutions often are more appropriate for such consumers. But in order to benefit consumers who could most use affordable loans, banks should either not check a credit score or set a very low credit score cutoff to ensure they are not excluding those who currently turn to high-cost alternative financial services (the vast majority of payday loan applicants have a credit score, and average FICO scores are in the low 500s).<sup>40</sup> Another key step to mitigating consumer risk is to ensure loan payments do not trigger overdraft fees. Incurring steep fees would undermine the case for these loans, which some consumers will use to help avoid overdraft fees. Banks should have no trouble ensuring that payments do not

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<sup>38</sup> The Pew Charitable Trusts, “Payday Loan Customers Want More Protections, Access to Lower-Cost Credit From Banks” (2017), 8, <https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/04/payday-loan-customers-want-more-protections-access-to-lower-cost-credit-from-banks>.

<sup>39</sup> For a summary of this research, see Pew’s comment letter on the CFPB’s 2016 proposed rule on payday, vehicle, and certain high-cost installment loans, part 1, p. 83 – Appendix C, <https://www.regulations.gov/document?D=CFPB-2016-0025-142716>). A guideline limiting monthly payments to 5 percent of the borrower’s monthly gross income would protect the borrower by shielding 95% of his or her income while giving the lender a simple, low-cost method for preventing monthly installment payments from becoming too large.

<sup>40</sup> Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman, *Payday Loan Choices and Consequences*, Oct. 11, 2012, Vanderbilt Law and Economics Research Paper No. 12-30, <http://dx.doi.org/10.2139/ssrn.2160947>.

trigger overdraft fees on checking accounts that they hold, but the FDIC may wish to allow banks leeway to avoid compliance problems if they promptly refund overdraft fees that may inadvertently occur from time to time.

#### **8. What are the potential benefits and risks related to banks partnering with third parties to offer small-dollar credit?**

A large share of banks will turn to service providers to offer these loans through mobile or online banking platforms. It would simply be impractical to build out such a program in house for any but a large institution. These partnerships can help banks offer small loans in largely automated fashion without requiring a hefty upfront investment or substantial staff time. Service providers' offering a white-labeled platform available through mobile or online banking is likely to substantially improve small and medium-sized banks' ability to offer small installment loans. This type of third-party relationship, as long as it is carefully monitored by the bank to ensure compliance with its standards and regulatory requirements, is likely to benefit consumers by making bank-issued, affordable loans available to them through the bank's online or mobile banking platform.

However, third-party relationships where a payday or other non-bank lender uses a bank's charter to originate high-cost loans that would otherwise violate state usury laws put consumers at extreme risk. For example, payday and other high-cost lenders have issued single-payment and multi-payment loans with unaffordable terms at extremely high prices by partnering with banks that used their charters to preempt state price limits and other consumer protections. These loans and lines of credit are far more expensive than those that banks would offer to their own customers, and they have the effect of undermining state-level consumer safeguards. These kinds of relationships are nothing like banks using service providers to simplify lending to their own customers. We were pleased that the Office of the Comptroller of the Currency expressed in its May 2018 bulletin on small-dollar lending that it "views unfavorably" such relationships.<sup>41</sup>

#### **9. What steps could the FDIC take, consistent with its statutory authority, to encourage banks to develop and offer responsible, prudently underwritten small-dollar credit products?**

The FDIC should clarify that prices should not be higher than necessary to profitably make small credit available, but prices higher than the 36 percent rate used in the FDIC's Small-Dollar Loan Pilot are acceptable. We share the OCC's view that "pricing should be reasonably related to product risks and costs." But the OCC has never suggested a maximum rate of 36 percent for small loans, so their bulletin's excluding specific pricing was not likely to cause confusion among banks. The FDIC, however, has suggested a 36 percent rate limit in the past, meaning banks should charge no more than \$24 for a \$400, 3-month loan.<sup>42</sup> Therefore, the FDIC should be more explicit about acceptable pricing. Pew's

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<sup>41</sup> Office of the Comptroller of the Currency, U.S. Department of Treasury, "Description: Core Lending Principles for Short-Term, Small-Dollar Installment Lending," OCC Bulletin 2018-14, May 23, 2018, <https://www.occ.gov/news-issuances/bulletins/2018/bulletin-2018-14.html>.

<sup>42</sup> For example, the FDIC wrote in a 2007 Financial Institution Letter covering Affordable Small-Dollar Loan Guidelines that it encouraged "lenders to offer small-dollar credit with APRs no greater than 36 percent." Based on new research, experience gained, and the FDIC's 2008-2009 Small-Dollar Loan Pilot, at this point it is clear that

research has found that if banks use automation to process applications, underwrite, and originate small installment loans, they can profitably do so at double-digit APRs, with rates declining as loan sizes increase. In dollar terms, banks can be profitable while charging about six times less than payday lenders. For example, to borrow \$400 for three months from a payday lender would cost an average of \$360. If banks make sufficient use of automation, they will be profitable if they charge \$50-\$60 on a loan of this size and duration (U.S. Bank is charging \$48 if consumers agree to auto-pay).<sup>43</sup>

The historical 36 percent rate cap adopted by many state legislatures as part of a compromise between the Russell Sage Foundation and a group of consumer finance companies was for loans far larger than typical payday or other small-dollar credit today.<sup>44</sup> When the Uniform Small Loan Law was drafted in 1916, it was for loans of \$50–\$300 at that time, or roughly \$1,100–\$6,600 in today’s dollars.<sup>45</sup> But even at that time, very little credit was extended in amounts less than \$75 at that price (about \$1,650 today), and lenders primarily earned profits from the larger loans.<sup>46</sup> Thirty-six percent APR is too high a price for a loan of \$6,600, but it is too low a price to enable sustainable lending of \$500 or even \$1,000. One of the key lessons of the Uniform Small Loan Law is that having one rate for a variety of loan sizes was an error. Higher rates are needed for very small loans, and lower ones are appropriate for larger loans. The focus on small loans having low rates has bolstered the payday loan market and excluded millions of Americans from the financial mainstream.

Application and other fees that are excluded from the loan’s APR make little sense in the context of a high-volume, automated, small-loan program, and they should be excluded or tightly constrained. There may be a temptation for regulators, examiners, and banks to allow application fees plus an interest rate in order to show an artificially low APR. A \$400, 3-month loan at a cost of \$60 has an 88 percent APR, as noted below, but the APR would be just 15 percent if the same charge were structured as a \$50 application fee plus 15 percent interest (an additional \$10). But this practice hurts consumers, because they generally fare better with costs spread evenly over the life of the loan. It also damages the integrity of the Truth in Lending Act and the banking system generally by obscuring the true cost of the loan, making it difficult to compare costs with other loans, and by creating de facto prepayment penalties (large front-loaded fees generally are not refunded upon early repayment). Conversely, transparently priced small installment loans are more consumer friendly and do not raise unacceptable reputational risks. For example, 80 percent of Americans think that a \$60 charge for a \$400, three-month loan is fair—that results in the 88 percent APR noted above. Similarly, when Americans were asked whether banks offering such loans is a bad thing because the rates are higher than credit cards, or a good thing

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banks are not profitable offering small loans at 36 percent, meaning a \$200, 2-month loan for \$9, or a \$300, 3-month loan for \$18.

<sup>43</sup> On a \$400 loan repaid over three months with a fee of \$48, the TILA APR is 71 percent. This price is reasonable for a small installment loan that has affordable payments, other safeguards, and is made to a customer with a damaged credit score.

<sup>44</sup> Lendol Calder, “Financing The American Dream” (1999), 109-147.

<sup>45</sup> Bruce G. Carruthers, Timothy W. Guinnane, and Yoonseok Lee, “Bringing ‘Honest Capital’ to Poor Borrowers: The Passage of the U.S. Uniform Small Loan Law, 1907-1930.”

<sup>46</sup> Anne Fleming, “City of Debtors: A Century of Fringe Finance” (2018).

because the prices are six times lower than payday loans, by nearly a 5-to-1 ratio, they think it would be a good thing.<sup>47</sup>

Pew has identified three core elements that are essential to any small-dollar loan program that works well for providers and consumers: fair prices, affordable installment payments, and reasonable time to repay.<sup>48</sup> For small installment loans from depository institutions, Pew has suggested that a fair pricing scheme reflective of the recommendations discussed in this section would consist of an interest rate, such as 18 percent, plus a monthly maintenance fee of 4 percent of the original loan amount capped at \$20 per month.<sup>49</sup> Structuring the monthly fee in this way would spread costs evenly over the life of the loan, result in a transparent and double-digit APR, and ensure that costs are proportional to the size of the loan while APRs decline steadily for larger loan sizes.

### **Challenges**

#### **10. Are there any legal, regulatory, or supervisory factors that prevent, restrict, discourage, or disincentivize banks from offering small-dollar credit products? If so, please explain.**

The CFPB's 2017 final rule on payday loans in no way prevents banks from offering small installment loans or lines of credit, provided that consumers receive more than 45 days to repay in multiple installments. On the contrary, for loans with terms beyond 45 days that carry no balloon payments, that regulation explicitly does not create new requirements or burdens for banks.

Even if the CFPB's rule is revisited, there is little concern that it will become more restrictive in how it approaches small installment loans. The chief elements of regulatory uncertainty for banks are whether the FDIC's Deposit Advance guidance applies to small installment loans or lines of credit, or only to single-payment loans, and what supervisory expectations the FDIC and its examiners have for bank-issued small installment loans and lines of credit. For example, if a bank issues 3-month small installment loans, where the balance declines evenly each month, and four percent of dollars lent are charged off, that equates to an annualized loss rate of 24 percent. With sufficient revenue from appropriate pricing, banks will likely find such losses manageable, and the loan program would be safe and sound. But examiners may balk at seeing this type of annualized loss rate, discouraging banks from offering such credit. Similarly, examiners may not be used to seeing loans extended to customers with

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<sup>47</sup> The Pew Charitable Trusts, "Americans Want Payday Loan Reform, Support Lower-Cost Bank Loans" (2017), 8, <https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/04/americans-want-payday-loan-reform-support-lower-cost-bank-loans>.

<sup>48</sup> These elements are discussed in detail in The Pew Charitable Trusts, "Standards Needed for Safe Small Installment Loans from Banks, Credit Unions" (2018), <https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2018/02/standards-needed-for-safe-small-installment-loans-from-banks-credit-unions>. Also attached as Appendix A.

<sup>49</sup> See, e.g., Pew's comment letter to the NCUA's Notice of Proposed Rulemaking on the Payday Alternative Loan Program RIN 3133-AE84 (August 3, 2018), page 7, <https://www.ncua.gov/files/comment-letters/2018/comment-pal-20180803NBourke.pdf>.

low credit scores, or loans issued using simple and automated underwriting.<sup>50</sup> So setting supervisory expectations and communicating them to examiners will be crucial for the success of any small-loan program. These expectations will be especially important to communicate around pricing, annualized loss rates, consumers' credit scores, and the need for simple and automated underwriting.

**11. Are there any operational, economic, marketplace, or other factors that prevent, restrict, discourage, or disincentivize banks from offering small-dollar credit products? If so, please explain.**

Conventional, manual processing of each loan application that involves staff time to underwrite and originate each loan is simply not feasible if banks are going to offer fairly priced small installment loans at scale. Such processes may work for larger loans or for ad hoc small-loan programs, but they are both too costly for banks and too cumbersome for bank customers who today turn to payday and other high-cost lenders. Regulators will need to be sensitive to banks' need to automate origination and maintenance of small installment loans, while also working to ensure affordable installment payments, reasonable time to repay, and fair pricing as discussed elsewhere in this letter (see Question 14).

Questions about potential reputational risk associated with small installment loan programs serving customers with damaged credit scores often comes up in discussions on this issue. As discussed in Question 9 and elsewhere in this letter, there is strong evidence that providing small installment loans would be *reputation-enhancing* for banks, even though disclosed APRs would be higher than credit cards or other conventional loans, as long as APRs remained in the double-digits and the loans are structured with affordable payments and reasonable time to repay. For example, 70 percent of Americans want to see banks begin to offer small loans to their customers who have low credit scores, and the same percentage would view banks more favorably if they did so.<sup>51</sup>

**12. What factors may discourage consumers from seeking responsible, prudently underwritten small-dollar credit products offered by banks?**

When consumers are in financial distress and seek to borrow small sums, they focus primarily on three factors: certainty of approval, ease of obtaining funds, and how quickly they can receive the loan proceeds. Payday and other high-cost lenders know this and compete accordingly. Therefore, speed, ease, and certainty must be paramount for banks to compete successfully. If banks do not offer loans as quickly and simply as payday lenders, or consumers do not believe they will qualify for small bank loans, consumers will continue to borrow outside of banks.

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<sup>50</sup> Almost all payday loan applicants have a credit score, and in one study, the average FICO score was 517. Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman, *Payday Loan Choices and Consequences*, Oct. 11, 2012, Vanderbilt Law and Economics Research Paper No. 12-30, <http://dx.doi.org/10.2139/ssrn.2160947>. To provide a true alternative to harmful, costly non-bank credit options, regulators will have to accept lending small amounts of money to customers with low credit scores, or without checking credit scores.

<sup>51</sup> The Pew Charitable Trusts, "Americans Want Payday Loan Reform, Support Lower-Cost Bank Loans" (2017), 3-4, <https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/04/americans-want-payday-loan-reform-support-lower-cost-bank-loans>.



Banks can outcompete payday lenders on speed, ease, and certainty using automation. U.S. Bank for example, makes small loans available exclusively through mobile and online banking, makes applying quick and easy, and deposits loan funds faster than nonbank lenders. Therefore, consumers will choose these loans. Though consumers focus on speed, ease, and certainty, the affordability of payments and the cost of loans are what affect their financial health. In short, for small bank installment loans to improve consumers' well-being, they must check the three boxes consumers most care about when they are in financial distress—speed, ease, and certainty—as well as meet the two criteria that improve their financial health—affordable payments and reasonable prices.

A secondary factor that could discourage consumers from borrowing from banks would be if they could lose their bank account in the event of loan default. The FDIC should ensure that if banks offer small loans, consumers should not lose access to their checking or other accounts if they default on small-dollar loans, just as defaulting on an auto loan would not cause them to lose their checking account.

### **Product Features**

#### **13. Are there specific product features or characteristics of small-dollar loan products that are key to meeting the credit needs of consumers while maintaining prudent underwriting?**

Very few consumers can afford to repay loans in just two weeks without borrowing again, so giving them adequate time to repay in installments is crucial.<sup>52</sup> Pew's extensive research on the affordability of small loans has found that borrowers can typically afford to sacrifice about 5 percent of each gross paycheck (or 6 percent of each net paycheck or incoming deposit) toward loan payments. Using a simple payment-to-income ratio like this as a consumer safeguard in addition to automated underwriting is a strong consumer protection that enables access to credit without payments that overwhelm consumers' budgets.<sup>53</sup> Using a payment-to-income ratio appropriately results in shorter terms for smaller loans and longer terms for larger loans. For example, the median monthly incoming deposits for a deposit advance customer were about \$3,000—6 percent of that is \$180, a reasonable monthly payment size for such a borrower. Payday loan borrowers earn somewhat less, about \$2,500 gross monthly income, which would mean a monthly installment payment of about \$125. Accordingly, a \$500 loan would typically take between three and six months to repay. Though banks may choose to set loan sizes in \$100 increments, or particular minimum or maximum loan sizes for these programs, consumers have a variety of credit needs. As an example, pawn loans average about \$120, while auto title loans average about \$1,000. Some payday lenders have begun extending loans of more than \$2,500. As bank small installment loan programs mature, regulators should allow the flexibility for consumers to access a variety of loan sizes if banks are willing to provide them.

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<sup>52</sup> The Pew Charitable Trusts, "Payday Lending in America: How Borrowers Choose and Repay Payday Loans" (2013), 13-15, <https://www.pewtrusts.org/en/research-and-analysis/reports/2013/02/19/how-borrowers-choose-and-repay-payday-loans>.

<sup>53</sup> The Pew Charitable Trusts, Oct. 7, 2016, comment letter to Director Richard Cordray regarding "Proposed Rule for Payday, Vehicle Title, and Certain High-Cost Loans, Docket ID: CFPB-2016-0025," 44-53, <https://www.regulations.gov/document?D=CFPB-2016-0025-142716>.

Similarly, when consumers overdraft they borrow very small amounts of money, with most overdrafting amounts less than \$100. Some overdrafts are certainly mistakes, but 32 percent of those who overdraft primarily view it as a way to borrow money. If consumers use small installment loans instead, the FDIC should ensure payments on these small loans cannot trigger overdraft fees, or else borrowing to avoid overdrafts could become quickly self-defeating.

**14. Are there specific product features or characteristics that are key to ensuring the economic viability to a bank of responsible, prudently underwritten small-dollar credit products?**

Banks and service providers would be wise to follow U.S. Bank's lead and limit payments to 5 percent of income. Pew's research has found these payments to be affordable for the bulk of struggling consumers. Using a simple payment-to-income ratio avoids the difficulties of trying to determine whether one consumer can afford just 3 or 4 percent of a paycheck while another can truly afford 6 or 7 percent. Using a 5 percent gross (or 6 percent net) payment-to-income ratio is easy to automate, as U.S. Bank has done.

Automation is probably the single most important factor to ensuring the success of a small-loan program. Processing applications, underwriting, and originating loans absolutely must be automated, or else the program will not achieve scale, will require very high prices, or will not be profitable. Pricing loans to allow for the mutual success of banks and customers is also critical. If loan prices carry three-digit APRs, consumers may not sufficiently benefit because prices are too high, and banks may suffer reputational harm. If prices are too low, below 36 percent APR for small loans, programs will either not serve customers who have low credit scores and need help, or programs will not be profitable, so banks will be reluctant to scale them.

It is also worth noting that having access to the borrower's checking account and deposit stream is a critical element of risk management for any bank that operates this kind of small-loan program. The power to deduct required loan payments from regular deposit streams is what enables lenders to extend credit to consumers with damaged credit histories, who, by definition, present a higher risk of default than mainstream borrowers. This is true of payday lenders (who hold post-dated checks or establish ACH withdrawals timed to the borrower's payday) and banks alike. Banks are more likely to make small installment loans available, and at relatively low cost, if regulators look favorably on attempts to automate payments against the borrower's deposit stream.<sup>54</sup> In exchange for this power, however, regulators should promote strong safeguards, such as limiting each payment to 5 percent of the borrower's income or 6 percent of the borrower's deposits during the period.<sup>55</sup> Nonbank lenders have demonstrated it is possible to withdraw payments far larger than customers can afford when they

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<sup>54</sup> This suggestion would comply with the Electronic Fund Transfer Act. Our recommendation is that banks encourage customers to use automated payments to maximize the chances that customers repay successfully.

<sup>55</sup> Pew has previously discussed how allowing deposit account access in exchange for certain strong customer safeguards is the simplest and most powerful risk management and consumer protection tool available in small-loan programs. See e.g. The Pew Charitable Trusts, Oct. 7, 2016, comment letter to Director Richard Cordray regarding "Proposed Rule for Payday, Vehicle Title, and Certain High-Cost Loans, Docket ID: CFPB-2016-0025," 44-53, <https://www.regulations.gov/document?D=CFPB-2016-0025-142716>

have access to borrowers' checking accounts on payday. To avoid such abuses of this access, safeguards around affordability and ensuring payments do not trigger overdrafts are necessary.<sup>56</sup>

### **Innovation**

#### **15. How can technology improve the ability of banks to offer responsible, prudently underwritten small-dollar loan products in a sustainable and cost-effective manner? Please specify the technology or technologies and the use case(s).**

With the possible exception of the smallest loans offered as a customer acquisition strategy, under a new, large-scale small-loan program, banks should only offer this credit via online or mobile banking. Such channels will enable banks to compete on speed, ease of access, and certainty of approval, while also minimizing staff time and processing costs. We are aware of five to six service providers that offer turnkey small-loan programs that can be integrated with banks' online and mobile platforms. These providers base eligibility for small credit on consumers' history with the bank and other criteria. Whenever possible, small loans should be advertised only to consumers who have a high likelihood of approval to reduce uncertainty about whether they can qualify for these loans. By setting eligibility criteria for pre-screening, such as a certain length of time with the bank, having direct deposit, or the account being in good standing, banks can minimize processing applications that are likely to be declined, which discourages consumers from applying for bank loans and incurs costs for the bank.

#### **16. Are there innovations that might enable banks to better assess the creditworthiness of potential small-dollar loan borrowers with limited or no credit records with a nationwide credit reporting agency?**

Traditional credit reports and credit scores are of limited use in assessing the likelihood that bank customers will repay small installment loans.<sup>57</sup> Most consumers who use small-dollar loans have very low credit scores. There is simply little difference in likelihood to repay between two customers who have low credit scores that are modestly different. Instead, based on more than 100 conversations we have had with bank and credit union executives about this topic, much better predictors of likelihood to repay are length of account history, presence of direct deposit, and whether the account is in good standing. Banks may wish to observe a consumer's credit report or credit score, but if those with low credit scores are excluded from borrowing, then small-loan programs will not reach those customers that are most likely to turn to nonbank lenders. Because of the cost of pulling a credit report for a small institution and its limited predictive value for these loan programs, we strongly recommend that doing so not be required as part of determining eligibility for a small-dollar loan. Automated underwriting

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<sup>56</sup> The Pew Charitable Trusts, "Fraud and Abuse Online: Harmful Practices in Internet Payday Lending" (2014), <https://www.pewtrusts.org/en/research-and-analysis/reports/2014/10/fraud-and-abuse-online-harmful-practices-in-internet-payday-lending>.

<sup>57</sup> Sumit Agarwal, Paige M. Skiba, and Jeremy Tobacman, "Payday Loans and Credit Cards: New Liquidity and Credit Scoring Puzzles" (2009) <https://www.nber.org/papers/w14659>. The authors find that specialty data are much more predictive of payday loan repayment than FICO score.

conducted by a service provider that includes length of account history and presence of direct deposit among other factors is likely to be an excellent predictor of repayment.

**17. What role should the FDIC play, if any, in supporting innovations that enhance banks' abilities to offer responsible, prudently underwritten small-dollar loans? Are there specific barriers that prevent banks from implementing such technologies or innovations?**

The CFPB has cleared the way for banks to offer small installment loans with terms of more than 45 days.<sup>58</sup> The FDIC now has the most important role to play of any regulator at this point with respect to small-dollar bank installment loans. Even banks supervised by the OCC and Federal Reserve care deeply about the FDIC's views of small-dollar loans, because banks are reluctant to act in a way that is not aligned with their insurer's perceived wishes. The FDIC is also the only regulator that has highlighted a 36 percent APR as the maximum appropriate for very small loans to consumers with very low credit scores. This pricing, which is not viable, has prevented banks from offering fair small installment loans, harming consumers badly by leaving them to borrow on onerous terms outside the banking system. Double-digit APRs above 36 percent are viable. The FDIC has focused on consumer protection and financial inclusion in recent years. But to protect and include payday loan borrowers, it is necessary to welcome affordable and responsible small-dollar installment lending by banks.

The FDIC should also support innovation by collecting data on small-dollar loans, especially high-volume programs. Banks are likely to report these loans to credit bureaus, so the FDIC could also see whether consumers' credit score trajectories, use of alternative financial services, use of overdraft, or other indicators of financial well-being change after consumers gain access to small installment loans from banks. However, the FDIC should not treat bank small-dollar lending as a pilot program or a type of lending that is contingent on the results of a study. Banks and service providers could be reluctant to begin offering affordable small installment loans unless they know these loans will be viewed as acceptable to regulators for the long term.

**18. How can technology be leveraged to improve consumers' experiences and reduce potential risks to consumers associated with small-dollar credit products?**

Technology can be leveraged to ensure that borrowers can easily apply, are encouraged to opt in to automatic repayment, and are suggested the most appropriate credit product that meets their needs.

Many borrowers cite the ease of application as a reason why they use conventional payday loans, and banks will need to offer interfaces that provide the same or better levels of service to be competitive. Mobile and online banking can reduce the friction of application while enhancing customers' experiences.

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<sup>58</sup> In October 2017, the Consumer Financial Protection Bureau finalized a rule governing payday, vehicle title, and certain high-cost installment loans. The rule imposes certain "ability to repay" requirements on any loan with a term of 45 days or less, except for certain types of credit, such as overdraft, credit cards, and pawn. Installment loans and lines of credit lasting longer than 45 days are not covered by these requirements, except in unusual cases where the loan requires a "balloon payment" that is more than twice as large as any other payment.

Borrowers will be more successful repaying small installment loans if they use automatic repayment, thus preventing an unintentional missed or late payment that would show up on their credit report or lead them to lose eligibility to borrow. Incentives to choose auto-repayment, such as a small fee reduction, should lead to a higher probability that the borrower will use automatic payments and be successful using a small-dollar credit product.

Pew anticipates that most banks will pre-screen borrowers eligible for a small-dollar credit product. However, banks should be encouraged to offer eligible customers the lowest-cost credit product available. Technology can be used to enable pre-approval for products like lines of credit, personal installment loans, credit cards, and others that consumers can use to make purchases or smooth consumption. Ensuring customers are offered the optimal credit product could help meet their needs and save them money.

With respect to small-dollar installment loans specifically, using technology to evaluate a borrower's deposit history and automatically structure loan repayments that take no more than a small percentage of the borrower's deposits would provide a simple and effective way to ensure affordable payments.

### **Alternatives**

#### **19. What other products and services that supplement or complement small-dollar credit offerings should banks consider? Are there other ways that banks can help consumers address cash-flow imbalances, unexpected expenses, or income volatility besides small-dollar credit products?**

Pew's research shows that typical payday borrowers are in financial distress and failing out of the credit mainstream due to problems they have experienced managing bills and expenses, or because of a decline in income. Due to borrowers' past experiences and their acute financial need when applying for small-dollar credit, banks may be limited in their ability to consider alternatives while simultaneously offering the speed, certainty, and ease borrowers require. However, banks have an incentive to build a long-term customer relationship, and irrespective of any small-dollar loan program, they should offer to help borrowers to repair credit, successfully use traditional credit products, and build savings and assets in addition to addressing customers' immediate needs.

Nearly all banks offer some form of fee-based overdraft coverage, and roughly one-third of overdrafters report they view that as small-dollar credit. Banks often disclose that they offer overdraft coverage up to \$500 or so as a matter of course. But due to the per-incident, fee-based structure of overdraft programs, it is an extraordinarily expensive way to frequently borrow small sums of money. Overdrafters would be better served if they were able to obtain small-dollar installment loans from their banks rather than relying on overdraft coverage intended for occasional use.

Savings programs have merit, though requiring banks to make it easier for customers to save as a precondition to providing small-dollar loan programs would likely be counterproductive by overburdening the new credit programs. Similarly, despite the weak track record and general cost-ineffectiveness of financial literacy initiatives, banks may choose to offer such programs. But such efforts

should not be married to offering affordable small installment loans. Financial literacy initiatives are no substitute for offering beneficial credit, nor should they be an excuse to offer harmful deposit advances.

### **Other**

#### **20. Are there any distinguishing characteristics of particular institutions, such as a bank's size, complexity, or business model, that the FDIC should consider, and if so how?**

It will be impractical for small and even medium-sized banks to build out a program in house that can automate the processes of taking applications, prescreening for eligibility, underwriting, and originating loans. The costs of building such a program are simply too high for the limited revenue available at all but large institutions. Therefore, small and medium-sized banks are likely to use a service provider. Several service providers have already developed turnkey small-loan programs that can be white-labeled for institutions, so consumers can apply for small loans via the online or mobile banking platforms that most of them already use. Large banks are likely to build such programs in house, and they will need regulatory certainty to justify the cost and time needed for their development.

#### **21. Please provide any other comments or information that would be useful for the FDIC to consider.**

As the FDIC considers this crucial issue that will have a major impact on the well-being of millions of struggling American households, we offer several recommendations. Based on more than 100 conversations with bank and credit union executives, providers are uncertain whether the following practices are acceptable. The FDIC should make it clear to banks and examiners that the following five practices are acceptable and would not cause any regulatory concerns:

- 1) Offering small installment loans or lines of credit to their own checking account customers who have very low credit scores
- 2) Lending at double-digit APRs above 36 percent
- 3) Using simple, automated underwriting that relies primarily on the consumer's relationship with the bank, with clear safeguards like a 5 percent payment-to-income ratio
- 4) Using third-party service providers to automate the lending process
- 5) Having annualized loss rates that look high compared to other products, as long as at least 9 in 10 loans are repaid successfully

To convey that these practices are acceptable, we encourage the FDIC to join or echo the OCC's bulletin from May 2018, encouraging bank small installment loans with terms of more than 45 days. This bulletin laid out sound principles for small installment loans and did not welcome back harmful single-payment deposit advances. We also encourage the FDIC to maintain its Deposit Advance guidance, but clarify that it applies only to loans with terms of 45 days or shorter.<sup>59</sup> Because of the FDIC's past highlighting of 36

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<sup>59</sup> Though the OCC rescinded its deposit advance guidance, the FDIC should not do so. A major justification for the OCC's move no longer applies: Citing the anticipated move by the CFPB to impose ability-to-repay and other requirements on loans lasting 45 days or less, the OCC noted that the CFPB rule would address certain risks

percent APR as a maximum rate for small-dollar loans in its pilot program, it should also ensure banks, service providers, and examiners understand that APRs in the high double digits, which decline as loan sizes increase, are likely to be necessary for banks to operate affordable small installment loan programs in a safe and sound manner.

Thank you for your consideration. Four appendices follow with relevant materials we have published on bank small installment loans.

Sincerely,



Nick Bourke  
Director, Consumer Finance  
The Pew Charitable Trusts

- Appendix A: Standards Needed for Safe Small Installment Loans from Banks, Credit Unions
- Appendix B: Momentum is Building for Small-Dollar Loans
- Appendix C: Americans Want Payday Loan Reform, Support Lower-Cost Bank Loans
- Appendix D: Payday Loan Customers Want More Protections, Access to Lower-Cost Credit From Banks

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regarding short-term loans and expressed concern that continuation of its own deposit advance guidance “would subject banks to potentially inconsistent regulatory direction and undue burden as banks prepare to implement the requirements of the CFPB’s rule.” 82 FR 47602 (October 12, 2017), <https://www.federalregister.gov/d/2017-22012/p-9>. But the CFPB has since announced formal plans to “reconsider” its rule, specifically the ability-to-repay underwriting provisions. CFPB, “Public Statement Regarding Payday Rule Reconsideration and Delay of Compliance Date” (October 26, 2018), <https://www.consumerfinance.gov/about-us/newsroom/public-statement-regarding-payday-rule-reconsideration-and-delay-compliance-date/>. It is now highly likely that the CFPB intends to remove some of the key underwriting considerations found in the deposit advance guidance for loans lasting less than 45 days, meaning the FDIC should be very cautious about removing protections on short-term advances—and at a minimum, should not alter or rescind its deposit advance guidance before the CFPB has finished reconsidering its own rule. Further, what banks really need now is clarity about small installment loans that last longer than 45 days, which are not covered by the CFPB’s rule. The FDIC can achieve its goals by clarifying that its deposit advance guidance applies only to short-term advances lasting 45 days or less, and publishing new guidance or policy statements addressing longer-term installment loans, which are not covered by the CFPB rule and which are the focus of this letter.



# Appendix A



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# Standards Needed for Safe Small Installment Loans From Banks, Credit Unions

Millions of borrowers could save billions of dollars annually

## Overview

Several recent developments have raised the possibility of banks and credit unions offering small installment loans and lines of credit—which would provide a far better option for Americans, who currently spend more than \$30 billion annually to borrow small amounts of money from payday, auto title, pawn, rent-to-own, and other small-dollar lenders outside the banking system. Consumers use these high-cost loans to pay bills; cope with income volatility; and avoid outcomes such as eviction or foreclosure, having utilities disconnected, seeing their cars repossessed, or going without necessities. Many of these loans end up harming consumers because of their unaffordable payments and extremely high prices; in the payday and auto title loan markets, for example, most borrowers pay more in fees than they originally received in credit.

Millions of households could benefit if banks and credit unions were to offer small installment loans and lines of credit with standards strong enough to protect consumers, clear enough to avoid confusion or abuse, and streamlined enough to enable automated low-cost origination.

Many credit unions and community banks already offer some small installment loans and lines of credit. But because regulators have not yet issued guidance for how banks and credit unions should offer small-dollar installment loans, or granted specific regulatory approvals for offering a high volume of such loans, these programs have not achieved a scale to rival the 100 million or so payday loans issued annually—let alone the rest of the nonbank small-dollar loan market. So, with most banks and credit unions either not offering small loans, or only offering them to people with relatively high credit scores, consumers with low or no credit scores looking to borrow small amounts of money often turn to alternative lenders in the nonbank market. Yet three-quarters of all households that use these alternative financial services already have accounts at banks or credit unions, and borrowers who take out payday loans in particular must have both an income and an active checking account to serve as collateral when their payments are due.

Now, the Consumer Financial Protection Bureau's (CFPB's) final small-loan regulation, issued in October 2017, permits providers to offer small installment loans and lines of credit with few restrictions—and adds strong consumer safeguards for loans with terms up to 45 days. Banks and credit unions have stated their interest in offering small installment loans and lines of credit, and some policymakers have expressed support for the idea. But while finalizing this rule was a necessary step for banks and credit unions to be able to offer such loans, it is not sufficient. In order for these loans to reach market, banks and credit unions will need to develop small-loan products, and their primary regulators—the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board of Governors, the Federal Deposit Insurance Corp. (FDIC), and the National Credit Union Administration (NCUA)—will need to approve the products.

The opportunity for more banks and credit unions to enter the small installment loan market is not without its challenges. In order for these traditional lending institutions to seriously compete with the large number of payday and other nonbank small-dollar lenders that market aggressively, many banks and credit unions—especially large ones—would need not only to offer small-dollar loans but to make sure that consumers are aware that they offer such loans. And banks and credit unions would need to compete with nonbank lenders on speed, likelihood of approval, and ease of application, because small-dollar loan borrowers usually seek credit when they are in financial distress.

But banks and credit unions would also enter the market with large comparative advantages over nonbank lenders, with their lower costs of doing business allowing them to offer loans profitably to many of the same borrowers at prices six times lower than those of payday and other similar lenders. The banks and credit unions would be lending in a largely automated fashion to known customers who already make regular deposits, so both their acquisition costs and automated underwriting costs would be lower than those of nonbank lenders. The cost of capital for banks and credit unions is the lowest of any provider, and their overhead costs are spread among the multiple products they sell.

The idea of banks offering small-dollar loans is not entirely new, and experience is instructive. Until regulators largely put a stop to the practice in late 2013, a small number of banks offered costly “deposit advances” that were due back in a lump sum on the borrower's next payday, at a fee most often of 10 percent per pay period—or roughly 260 percent annual percentage rate (APR). Regulators should not permit banks to reintroduce deposit advance loans; for consumers, it is also vital that any small-dollar loans from banks and credit unions not replicate the three key harms that characterized the deposit advance market: excessive pricing, unaffordable payments, and insufficient time to repay.

This brief includes guidelines for banks and credit unions to follow as they develop new small-dollar loan programs. The guidelines are designed to protect consumers and enable sustainability and scale for providers, who should offer small installment loans or lines of credit with the following features:

- Affordable installment payments of no more than 5 percent of each paycheck or 6 percent of deposits into a checking account.
- Double-digit APRs that decline as loan sizes increase.
- Total costs that are no more than half of loan principal.
- Loan payments that cannot trigger overdraft or nonsufficient funds fees.
- Online or mobile application, with automated loan approval, so that loan funds can be quickly deposited into a borrower's checking account.
- Credit bureau reporting of loan terms and repayment.

## The status quo

The nonbank options for credit are often poor, with high-cost loans dominating the landscape. Twelve million Americans use payday loans annually, and many others use different forms of high-cost credit.<sup>1</sup> The FDIC has found that 20 percent of all American households are underbanked, meaning that they use alternative financial services in addition to using banks and credit unions.<sup>2</sup>

The bulk of research on payday lending has focused on whether consumers fare better with access to loans with unaffordable payments that carry APRs of around 400 percent, or whether, instead, these loans should be banned and small-dollar credit made mostly unavailable. But such research incorrectly assumes that these are the only two possibilities, especially since other studies have shown that consumers fare better than they do with payday loans when they gain access to alternatives featuring affordable installment payments and lower costs.<sup>3</sup>

Payday lenders' products are so expensive because they operate retail storefronts that serve an average of only 500 unique borrowers a year and cover their overhead selling few financial products to a small number of customers. Two-thirds of revenue goes to handle operating expenses, such as paying employees and rent, while one-sixth of revenue covers losses.<sup>4</sup> They have higher costs of capital than do banks or credit unions, they do not have a depository account relationship with their borrowers, and they often do not have other products to which borrowers can graduate. Their customer acquisition costs are high, and because storefront lending requires human interaction, they make limited use of automation. The online payday loan market, while it avoids the costs that come with maintaining retail storefronts, has higher acquisition costs and losses than do retail payday loan stores.<sup>5</sup>

Banks and credit unions do not face these challenges on the cost side—and, because of customers' regular deposits into their checking accounts and pre-existing relationships with providers, the losses from small-loan programs run by banks and credit unions have been low.

## Giving consumers a better option

Many customers use high-cost loans, pay bills late, pay overdraft penalty fees as a way to borrow, or otherwise lack access to affordable credit. Being able to borrow from their bank or credit union could improve these consumers' suite of options and financial health, and keep them in the financial mainstream: The average payday loan customer borrows \$375 over five months of the year and pays \$520 in fees,<sup>6</sup> while banks and credit unions could profitably offer that same \$375 over five months for less than \$100.

Yet while 81 percent of payday loan customers would prefer to borrow from their bank or credit union if small-dollar installment loans were available to them there,<sup>7</sup> banks and credit unions do not offer such loans at scale today primarily because regulators have not issued guidance or granted specific regulatory approvals for how banks and credit unions should offer the loans. The CFPB appropriately issued strong final rules in October 2017 for loans lasting 45 days or less, removing some of the regulatory uncertainty that discouraged banks and credit unions from offering installment loans and lines of credit.<sup>8</sup> Because of the investment involved in launching a new product, and concern on the part of banks and credit unions about enforcement actions or negative reports from examiners, these traditional banking institutions will need clear guidance or approvals from their primary regulators—the OCC, the Federal Reserve, the FDIC, and the NCUA—before they develop small-loan products.

Experience with small-dollar loan programs suggests losses will be low. For example, over the past decade, certain banks and credit unions offered small-dollar loans under three regulated programs—the NCUA Payday Alternative Loan program, the FDIC small-dollar loan pilot, and the National Federation of Community Development Credit Unions pilot—and collectively they charged off just 2 to 4 percent of those loans.<sup>9</sup> Several providers, including Rio Grande Valley Multibank, Spring Bank, Kinecta Federal Credit Union, and St. Louis Community Credit Union's nonprofit partner Red Dough, have already adopted Pew's recommendation to set individual payments at no more than 5 percent of each paycheck, and all have found charge-off rates to be manageable.<sup>10</sup>

The following attributes distinguish safe loans from those that put borrowers at risk and should be used to evaluate bank and credit union small-loan offerings.

### Payment size

When making small loans to customers with poor credit scores, lenders typically obtain access to borrowers' checking accounts to help ensure repayment. While this helps lenders make credit available to more consumers by minimizing the risk that they will not get repaid, it also puts consumers at risk that lenders will take such large payments from their accounts that they will be unable to afford other expenses. This has been a pervasive problem in the market for payday, auto title, and deposit advance loans.

Extensive research, both in borrower surveys and in analysis of installment loan markets serving customers with low credit scores, shows that these borrowers can afford payments of around 5 percent of their gross paychecks<sup>11</sup> (or a similar 6 percent of net after-tax income). Using this threshold as a standard for affordable payments would help protect consumers whenever lenders take access to their checking accounts as loan collateral, while also providing a clear and easy-to-follow guideline that works well for lenders. To improve operational efficiency and keep costs down, banks and credit unions can assess customers' income based on deposits into checking accounts and automatically structure loans to have affordable payments that take no more than 5 percent of each gross paycheck or 6 percent of deposits into accounts.<sup>12</sup> This payment size is sufficient for borrowers to pay down their balances—and for lenders to be repaid—in a reasonable amount of time.

## Pricing and competitive factors

Small-loan markets serving customers with very low credit scores are competitive on many elements, but generally speaking not on price<sup>13</sup>—because those seeking this credit are in financial distress and focus primarily on speed, likelihood of approval, and ease of application.<sup>14</sup> To succeed in this market, any bank or credit union program must be competitive on these essential features. If banks and credit unions can achieve that, then they could leverage their strong competitive advantage by being able to offer loans profitably at much lower prices.

The payday loan market is typically characterized by 400 percent APRs, but banks and credit unions can be profitable at double-digit APRs as long as applicable rules allow for automated origination.<sup>15</sup> These APRs for small loans borrowed for short periods of time need not be as low as the APRs for credit-card debt to be broadly viewed as fair. For example, 80 percent of Americans think that a \$60 charge for a \$400, three-month loan is fair, though its APR is 88 percent.<sup>16</sup> (See Figure 1.) That \$60 cost is roughly six times lower than average payday loan pricing for the same loan. But bank or credit union loans or lines of credit with three-digit APRs should attract additional regulatory scrutiny—because those rates are unnecessary for profitability, because they may be indicative of inadequate underwriting, and because the public sees them as unfair, meaning that they could create reputational risk for a bank or credit union. And APRs should decline as loan sizes increase, because the relatively high APRs needed for very small loans to be profitable are not justified for larger loans.

Any fees charged, other than a small application or annual fee, should be charged monthly, in order to be spread evenly over the life of the loan. Such a structure does not penalize borrowers who repay early or create an incentive for lenders to refinance loans.

Figure 1

### Americans Say Planned Bank Small-Loan Prices Are Fair Respondents' opinions on proposed 5% payment loans



Notes: Respondents were read the following statement: "Here are some examples of small loans that might be available to people who have low credit scores. For each, please tell me whether you think the terms seem fair or unfair. (Insert item.) Do you think the terms seem fair or unfair? a) \$500 for a fee of \$100 paid back over 4 months, so a person who borrows \$500 will pay back \$600; b) \$500 for a fee of \$600 paid back over 4 months, so a person who borrows \$500 will pay back \$1,100; c) \$400 for a fee of \$60 paid back over 3 months, so a person who borrows \$400 will pay back \$460." Results are based on 1,205 interviews. The order of these statements was randomized in the survey. Numbers shown do not total 100 percent because "don't know" and "refused" responses (indicated in gray) were omitted.

Source: The Pew Charitable Trusts, "Americans Want Payday Loan Reform, Support Lower-Cost Bank Loans" (April 2017), 7, <http://www.pewtrusts.org/~media/assets/2017/04/americans-want-payday-loan-reform.pdf>

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## Repayment term

Few borrowers can afford to repay small loans in just a few weeks. At the same time, some payday lenders have set unreasonably long terms to earn more revenue, such as 18 months to repay \$500.<sup>17</sup> The CFPB's final small-loan rule takes the important step of steering the market toward terms of more than 45 days. To ensure that loan sizes and durations do not become excessive, some regulators and state lawmakers have set maximum terms for various loan programs, such as six months. A more flexible approach would be to ensure that the total cost of a small-dollar bank or credit union loan never exceeds half of the loan principal, which would discourage lenders from setting terms that are too long—because they cannot earn additional revenue from doing so. At the same time, such a limit would allow for terms long enough to accommodate loans larger than \$1,000 (the average size of an auto title loan).

Providers should be free to experiment with both installment loans and lines of credit, as long as all of the safeguards described in this brief are included. Some consumers, such as those who need to make a substantial purchase or handle an unusually large expense, may be more likely to repay under the discipline imposed by installment loans. For consumers facing income volatility, the flexibility offered by lines of credit could be a better fit.

## Automation

The cost of manually processing applications is too high to offer small loans at scale. So, to keep the cost of origination low—and to compete with nonbank lenders on speed and ease—banks and credit unions will need to largely automate the lending process, including determining eligibility, establishing the maximum loan size, processing applications, and disbursing funds. Some additional time would be required for banks or credit unions to process loan applications from people who are not already their customers, but the financial institutions may find it worthwhile to do so since it would mean acquiring new accountholders.

## Underwriting

As highly regulated institutions, banks and credit unions engage in underwriting to ensure that they are lending in a safe and sound manner. The underwriting criteria for small-dollar installment loans must be carefully tailored so that these loans can be competitive with more expensive options such as payday, auto title, or rent-to-own loans. The guidelines must allow for prescreening, high approval rates,<sup>18</sup> and fast origination at very low cost, similar to those employed for overdraft programs and other automated systems; otherwise, the provider would have to charge a high price to be profitable.

Prescreening customers to determine eligibility can improve the likelihood that the loans are advertised only to customers who are likely to be approved. Among customers with damaged credit, traditional metrics such as a credit score are limited in their effectiveness at assessing the likelihood of loan repayment. Therefore, relying primarily on a credit score to determine eligibility is likely to deny access to these customers, many of whom would otherwise use high-cost products. To mitigate this issue, providers should be able to experiment with underwriting criteria. Important elements are likely to include whether the customer is maintaining an account in good standing; the length of the customer's relationship with the bank or credit union; regularity of deposits; and the absence of any warning signs such as recent bankruptcies or major problems with overdrafts (a small installment loan would be better for most customers than paying several overdraft fees, but very heavy and



persistent overdrawing could indicate deeper financial troubles that would make further extension of credit unwarranted). At the same time, if criteria are too strict, banks and credit unions may be unable to serve customers who could most benefit from small credit, leaving them with more costly nonbank options.

Providers will necessarily underwrite differently when lending to people who are not current customers but are joining the credit union or bank specifically because of its small-loan offerings. Regulators should leave banks and credit unions the flexibility to adjust their underwriting to ensure that losses remain manageable, while also making loans available to customers who would otherwise turn to high-cost lenders or suffer adverse outcomes because they could not borrow. For loans with terms of just a few months, annualized loss rates may look high compared with conventional credit products, but that should not be cause for concern as long as the absolute share of loans charged off is not excessive.

## Credit reporting

Loans should be reported to credit bureaus so that borrowers can build a track record of successful repayment, which in turn could help them qualify for lower-rate financial products. To maximize customer success, borrowers should be automatically placed into electronic payments that coincide with days they are likely to have incoming deposits, which keeps losses lower for providers and increases the odds that customers will succeed. Customers must have a chance to opt out of electronic repayment and pay manually if they prefer.

## Convenience

In order to attract customers from payday and other high-cost lenders, banks and credit unions must offer loans that are at least as convenient. With sufficient automation, the loans can be far easier and faster to obtain than those from nonbank lenders. The pre-existing relationship between the bank or credit union and customer means the applications can be started through an online or mobile banking platform, with the funds deposited quickly into checking accounts. Applying for credit and receiving it electronically can be especially helpful to customers who seek credit outside of normal banking hours or who do not live near a branch of their bank or credit union. If, on the other hand, banks and credit unions offer loans that—while at a lower cost than those available through payday and other lenders—are not as fast or convenient, many customers will continue to leave the banking system to borrow money.

## Other safeguards

The characteristics described above would make small loans far safer than those available from payday and other nonbank lenders. But three additional protections can benefit consumers further, without discouraging banks and credit unions from lending:

- To ensure that loans are made in a safe and sound manner only to customers who have the ability to repay them, providers should ensure that no more than 1 in 10 loans default. There may be valid reasons for high default rates during downturns or after natural disasters, but if more than 1 in 10 loans consistently default, lenders should change their loan policies and practices so at least 9 in 10 customers succeed.<sup>19</sup>
- Small-dollar loans from banks and credit unions should not trigger overdraft or nonsufficient funds fees, which today are charged when payday and other nonbank loans overdraw accounts. This protection is feasible for traditional financial institutions because they both operate the checking account and service the loan. If a lender accidentally charges such a fee, the customer should receive a prompt refund.

- Each lender should ensure that it is extending only one small loan at a time to each customer.<sup>20</sup> If customers repay as agreed, they should be able to borrow again.

Figure 2 identifies the features that would make high-volume offerings of small installment loans and lines of credit from banks and credit unions safe. Programs that use automation and seek to achieve scale should meet all of these criteria. Existing, low-cost, ad hoc, or low-volume programs from community banks and credit unions that are not automated tend to have many consumer-friendly features, though they do not meet all of these criteria.

Figure 2

## Safe, Small Installment Loans Should Meet All of These Criteria

Checklist for new, scalable, consumer-friendly small-dollar credit from banks and credit unions



Serves customers who would ordinarily use higher-cost small loans by offering installment loans or lines of credit



Payments are no more than 5 percent of paycheck or 6 percent of deposits



Annual percentage rates do not exceed double digits, inclusive of all fees, with rates declining as loan sizes increase



Total cost is no more than half of principal



Costs are spread evenly, other than annual or small application fee



Loan payments cannot trigger overdraft or nonsufficient funds fees



Reports are sent to credit bureaus



Borrowers may take only one loan at a time



No more than 1 in 10 of each institution's small installment loans is charged off



Loans are available quickly through online and mobile banking

## Conclusion

For too long, consumers who are struggling financially have had poor options when they seek to borrow small sums of money. These consumers are mostly bank and credit union customers, and it is imperative for their financial health that regulators, banks, credit unions, and other stakeholders find a way for them to gain access to better credit than that offered at high cost by nonbank lenders. Seventy percent of Americans report that they would have a more favorable view of their bank or credit union if it offered a \$400, three-month loan for \$60, and 80 percent believe that such a loan is fair<sup>21</sup>—as do 86 percent of payday loan borrowers.<sup>22</sup> Around this price point, 90 percent of current payday loan customers would rather borrow from a bank or credit union.<sup>23</sup> Numerous banks and credit unions are interested in offering small loans with the consumer-friendly characteristics laid out in this brief. With clear guidelines from regulators, that credit could reach the market and millions of Americans who are using high-cost loans today could save billions of dollars annually.

## Endnotes

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- 2 Federal Deposit Insurance Corp., "2015 FDIC National Survey of Unbanked and Underbanked Households" (October 2016), <https://www.fdic.gov/householdsurvey/2015/2015report.pdf>.
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- 4 The Pew Charitable Trusts, "Payday Lending in America: Policy Solutions," 28.
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- 10 The Pew Charitable Trusts, Oct. 7, 2016, comment letter to Director Richard Cordray regarding "Proposed Rule for Payday, Vehicle Title, and Certain High-Cost Loans, Docket ID: CFPB-2016-0025," 28, <https://www.regulations.gov/document?D=CFPB-2016-0025-142716>.
- 11 *Ibid.*, Appendix C.
- 12 To gain a more complete financial picture, providers may wish to ask the applicant to state his or her income on the loan application, especially for joint accounts, but payment size should be determined using verified income or deposits, not stated income.
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- 18 Although providers' underwriting criteria will vary, they should all target loans to customers who are likely to be approved and make those loans available via online or mobile banking so that customers do not become discouraged and turn to high-cost lenders.
- 19 This recommendation refers to the proportion of loans defaulting, but it intentionally does not use annualized loss rates to measure that share. Annualizing losses on short-term loans, but not outstanding balances, tends to yield a high annualized default rate even when relatively few loans go unpaid.
- 20 Pew intends this recommendation to ensure that banks or credit unions do not issue more than one loan at a time to each borrower, but that does not mean that, when using third-party vendors, these lenders should be required to check the records of other providers using the same vendor.
- 21 The Pew Charitable Trusts, "Americans Want Payday Loan Reform," 4, 7.
- 22 The Pew Charitable Trusts, "Payday Loan Customers Want More Protections," 11.
- 23 Ibid., 7.

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**For further information, please visit:**

[pewtrusts.org/small-loans](https://pewtrusts.org/small-loans)

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**The Pew Charitable Trusts** is driven by the power of knowledge to solve today's most challenging problems. Pew applies a rigorous, analytical approach to improve public policy, inform the public, and invigorate civic life.

# **Appendix B**

# Momentum is Building for Small-Dollar Loans

Opinion

September 12, 2018

By: [Nick Bourke](#)

Topics: [Fiscal & Economic Policy](#)

Projects: [Small Dollar Loans Research Project](#)

U.S. Bank's [announcement this week](#) that it will begin offering a new small installment loan could be the start of a new era — one in which regulated banks and credit unions offer small-dollar loans that most consumers can afford.

The loan features monthly payments that don't exceed 5% of a borrower's monthly income, with prices markedly lower than the payday, pawn, auto title or rent-to-own loans for which the effective annual percentage rates often top 300%. A \$400, three-month loan from U.S. Bank would cost \$48, compared with about \$350 from a payday lender.

This welcome development from a bank with more than 3,000 branches across the country could provide a safer option to consumers who have until now been largely excluded from access to affordable small-dollar credit. The announcement follows the Office of the Comptroller of the Currency's [May bulletin](#), which for the first time gave mainstream providers the regulatory certainty they need in order to offer affordable installment loans.

When the Pew Charitable Trusts surveyed payday loan customers about numerous possible reforms, [the single most popular](#) was enabling banks and credit unions to offer small loans at significantly lower prices than those charged by payday lenders. Pew research has found — and U.S. Bank's actions now demonstrate — that banks and credit unions have [such a large competitive advantage](#) that they can offer loans at prices that are six to eight times lower than payday lenders and still make a profit. The annual percentage rates have to be higher than those on credit cards, of course, but [neither the public](#) nor the payday loan borrowers we surveyed see that as unfair as long as APRs do not exceed double digits.

Until recently, a lack of regulatory clarity on what is and is not acceptable has prevented banks from offering small loans. But that started to change even before the OCC announcement in May. First, in 2016, representatives of 10 banks and 10 nonprofit



public interest organizations [agreed on reasonable standards](#) that would make large-scale, profitable, consumer-friendly small-dollar loans feasible. Then, last October, the federal Consumer Financial Protection Bureau issued [rules](#) that leave providers free to offer safe, small installment loans and lines of credit with few restrictions if the loans have terms of more than 45 days. At the same time, technological innovation has enabled automated underwriting and origination, with loan applications processed via mobile or online banking and the proceeds deposited into customers' accounts the same day — saving banks money and time, and enabling consumers to borrow more quickly from banks than they can from payday lenders.

U.S. Bank is just one of several large, national banks that have shown interest in offering safe small installment loans to borrowers if permitted by regulators. Evidence suggests that these loans will be very popular and that as long as banks abide by strong standards for safety and affordability, consumers will be big winners. Americans spend more than \$30 billion a year to borrow small amounts of money from lenders outside the banking system, and even in states to which payday lenders point as models, such as Florida, interest rates exceed 200%. So the potential savings to low- and moderate-income borrowers from gaining access to double-digit APR bank loans could top \$10 billion annually — more than the federal government spends on many anti-poverty programs.

Credit unions have the same competitive advantages as banks, which would allow them to also offer small-dollar loans at scale if their regulator, the National Credit Union Administration, were to authorize them to do so. Its board chairman, Mark McWatters, [took a promising step](#) in that direction this year when he issued a request for comment about a new payday alternative loan program that could make these lower-cost small loans feasible for credit unions.

In the Pew survey, four in five payday loan customers said they would prefer to borrow from their banks or credit unions — and all these borrowers already had checking accounts, because it's a requirement for getting a payday loan. A third of checking account customers who pay high fees to overdraw their accounts report that they do so as a way to borrow money when they're short on cash; many of them are likely to use new bank or credit union small-dollar loans if they gain that option. Moreover, loan payments would be reported to credit bureaus to help customers establish a successful track record of repayment.

[Standards for these small loans](#) are necessary to protect consumers, enable automation and simplify regulatory compliance. Research shows that setting payments at 5% of income, as U.S. Bank has done, is affordable for borrowers while enabling lenders to be repaid over the course of several months. Some public interest groups and banks have already expressed support for this moderate standard.

The OCC [appears to recognize](#) that many bank customers currently have no good way to cover expenses when they're in a financial bind and also appears to acknowledge the negative consequences of payday lending. By offering struggling customers safe credit,

banks can solve both these problems with small installment loans. U.S. Bank's announcement shows that offering such loans is possible without returning to the bad old days of "deposit advance" products that simply mimicked lump-sum payday loans. To build on this success, the Federal Reserve Board and Federal Deposit Insurance Corp. should echo the OCC's bulletin and give their supervised institutions the regulatory certainty they need to offer small installment loans. The CFPB should leave in place its 2017 small-dollar loan rule to protect consumers. And other banks should rise to the occasion and offer small-dollar installment loans — giving their millions of customers who today turn to high-cost lenders a much better option when it comes to borrowing money.

*This article was previously published in [American Banker](#).*

# **Appendix C**



# Americans Want Payday Loan Reform, Support Lower-Cost Bank Loans

Results of a nationally representative survey of U.S. adults

## The Pew Charitable Trusts

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## Acknowledgments

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## Overview

Typical payday loans have unaffordable payments, unreasonable durations, and unnecessarily high costs: They carry annual percentage rates (APRs) of 300 to 500 percent and are due on the borrower's next payday (roughly two weeks later) in lump-sum payments that consume about a third of the average customer's paycheck, making them difficult to repay without borrowing again.

In June 2016, the Consumer Financial Protection Bureau (CFPB) proposed a rule to govern payday and auto title loans<sup>1</sup> that would establish a process for determining applicants' ability to repay a loan but would not limit loan size, payment amount, cost, or other terms. The CFPB solicited and is reviewing public comments on whether to include in its final rule alternatives to this process with stronger safeguards, particularly a "5 percent payment option" that would limit installment payments to 5 percent of monthly income, enabling banks and credit unions to issue loans at prices six times lower than those of payday lenders at scale. As such, it would be likely to win over many payday loan customers.<sup>2</sup>

An analysis by The Pew Charitable Trusts determined that the CFPB's proposal would accelerate a shift from lump-sum to installment lending but, without the 5 percent option, would shut banks and credit unions out of the market, missing an opportunity to save consumers billions of dollars a year.<sup>3</sup>

To gauge public opinion on various reforms, including the proposed rule, Pew surveyed 1,205 American adults and found:

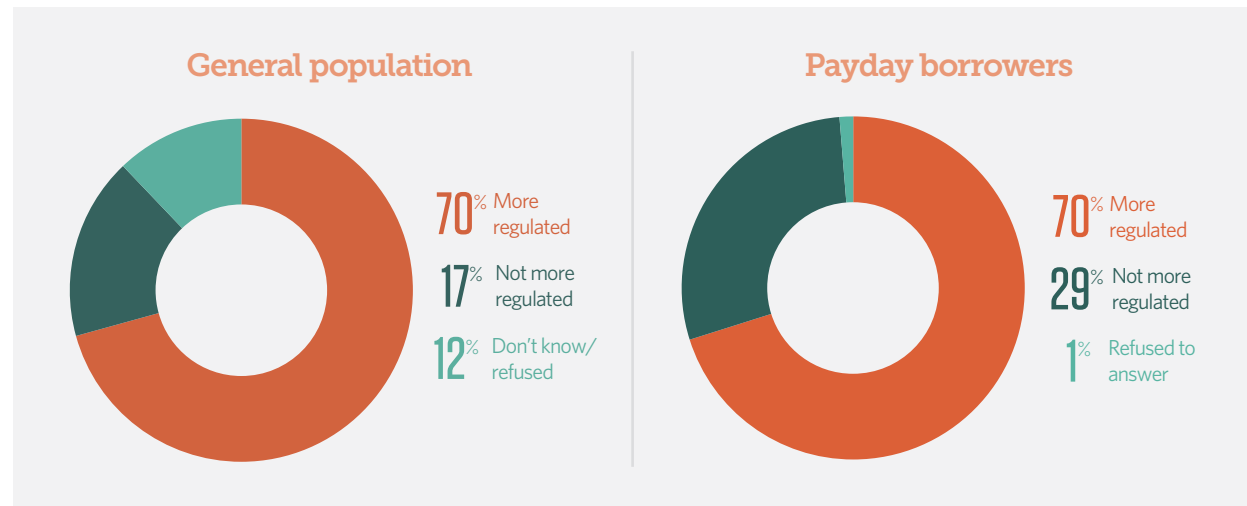
- 70 percent of respondents want more regulation of payday loans.
- 7 in 10 adults want banks to offer small loans to consumers with low credit scores, and the same proportion would view a bank more favorably if it offered a \$400, three-month loan for a \$60 fee (as reportedly planned).
- When evaluating a loan regulation's effectiveness, Americans focus on pricing rather than origination processes.
- Respondents say typical prices for payday installment loans that would probably be issued under the proposed rule are unfair.
- 80 percent dislike the proposal's likely outcome of 400 percent APR payday installment loans with more time to repay, but 86 percent say enabling banks and credit unions to offer lower-cost loans would be a success.

These results show that the public supports the CFPB's actions but strongly favors allowing banks and credit unions to offer lower-cost loans. A separate Pew survey of payday loan borrowers found similar sentiments.<sup>4</sup> This chartbook delves more deeply into these findings and discusses recommended changes to the proposal, including adoption of the 5 percent payment option, which is supported by Pew as well as many banks, community groups, and credit unions.

Figure 1

## 7 in 10 Americans, Borrowers Want Payday Loans to Be More Regulated

Percentage of respondents, by survey group



Roughly 12 million Americans use payday loans annually, spending an average of \$520 on fees to repeatedly borrow \$375.<sup>5</sup> Borrowers and the general population support more regulation of the small-loan industry in equal proportions.

Notes: Respondents were read the following statement: "Now I'd like to ask you some questions about payday lending. Payday lenders are companies that generally operate through storefronts or the internet. They make small loans, often at high interest rates that are usually due back on the borrower's next payday." Then they were asked: "Which of these statements comes closer to your point of view? 1) Payday loans should be more regulated; 2) Payday loans should not be more regulated." Results are based on 1,205 interviews. General population numbers do not total 100 percent due to rounding. The payday borrower data are from a separate survey of payday loan borrowers that was conducted online, and "don't know" was not presented as an option, though respondents could decline to answer.

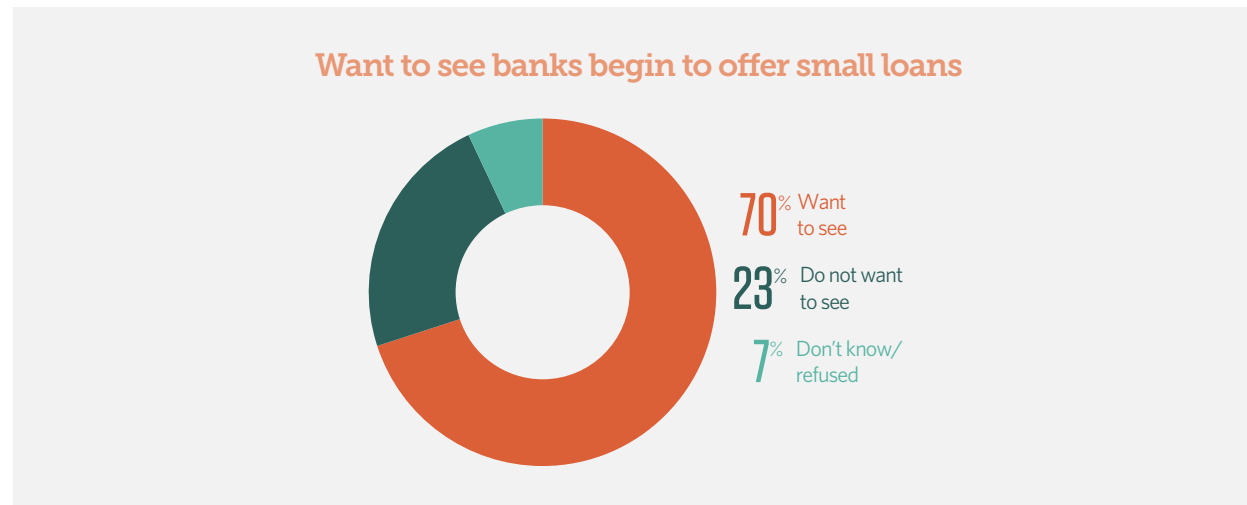
Source: The Pew Charitable Trusts, "Payday Loan Customers Want More Protections, Access to Lower-Cost Credit From Banks" (2017), [www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/04/payday-loan-customers-want-more-protections-access-to-lower-cost-credit-from-banks](http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/04/payday-loan-customers-want-more-protections-access-to-lower-cost-credit-from-banks)

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Figure 2

## 7 in 10 Americans Want Banks to Offer Small Loans to Borrowers With Poor Credit

Percentage of respondents



Notes: Respondents were asked: "Today, banks generally do not make loans to people with low credit scores. Do you want to see banks begin to offer small loans of a few hundred dollars to their customers who have low credit scores, or do you not want to see that?" Results are based on 1,205 interviews.

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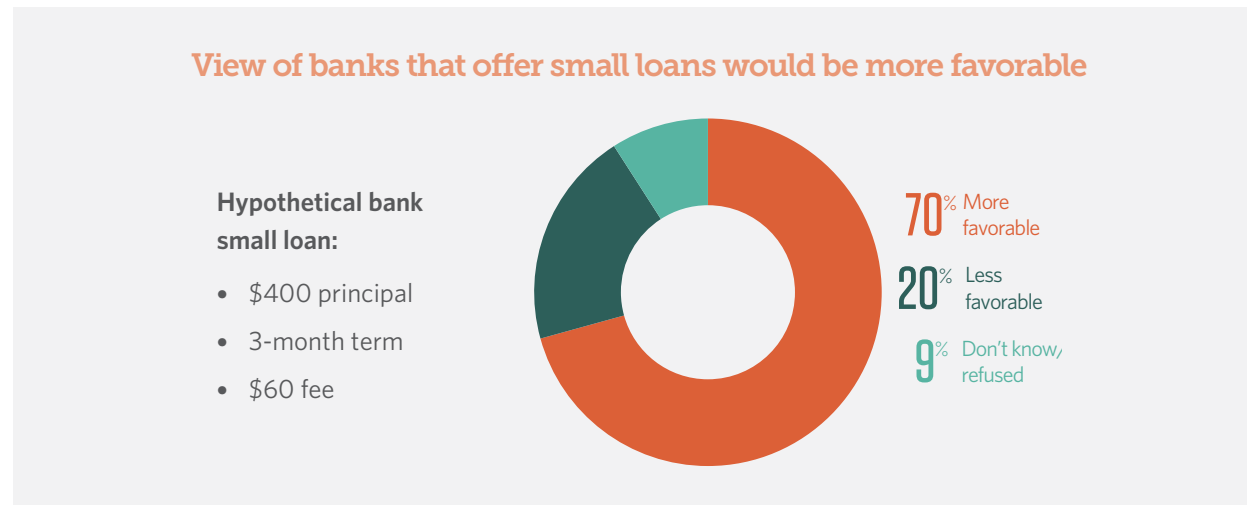
Banks generally cannot profitably make loans to people with low credit scores in the current regulatory environment. In May 2016, *American Banker* reported that at least three large banks were planning to use the 5 percent payment option that the CFPB proposed in its 2015 framework to offer such customers small loans repayable in affordable installments at prices roughly six times lower than average payday loans, such as a \$400, three-month loan for a \$60 fee.<sup>6</sup> Most Americans would like to see banks begin offering these loans.



Figure 3

## 70% of Americans Would View a Bank More Favorably if It Offered Lower-Cost Small Loans

Percentage of respondents



Seventy percent of survey respondents said they would have a more favorable view of a bank if it offered a \$400, three-month loan for a \$60 fee (as some banks are planning to do).<sup>7</sup> Banks report that they would need to use the 5 percent payment option in order to make these loans available.

Notes: Respondents were asked: "Some banks are considering offering a \$400, three-month loan with a \$60 fee. Payday lenders charge about \$350 for the same loan, while using a credit card would usually cost less than \$60. If a bank began offering a \$400, three-month loan for a \$60 fee, would your view of that bank be more favorable or less favorable?" Results are based on 1,205 interviews. Numbers do not total 100 percent due to rounding.

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Figure 4

## Americans Say Loans That Have More Time to Repay but Still Carry 400% APRs Would Be a Negative Outcome

Percentage of respondents in favor of each possible result



Notes: Respondents were read the following statement: "The government agency that regulates payday lending has proposed some new regulations. I'd like to get your opinion on some of the possible outcomes of the new regulations. For each, please tell me if you would view it as mostly a good outcome or mostly a bad outcome. a) If most people who use payday loans got more time to repay them, but the annual interest rates continued to be around 400 percent; b) If most people who use payday loans could get loans from their banks and credit unions that cost six times less than payday loans; c) If some payday lenders went out of business, but the remaining lenders charged less for loans." Results are based on 1,205 interviews. The order of these statements was randomized in the survey. Numbers do not total 100 percent because "don't know" and "refused" responses (indicated in gray) were omitted.

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The most likely outcome of the CFPB's June 2016 draft rule would be to shift the market to longer-term payday installment loans. Similar loans today carry interest rates of around 400 percent, and prices would not be likely to decline under the proposal. Most Americans view that as a bad outcome. If the CFPB modified its proposed rule to include the 5 percent payment option it featured in the 2015 framework, banks and credit unions would be likely to offer lower-cost loans, creating a better alternative for borrowers. The public overwhelmingly said that would be a good result.

Figure 5

## Americans Care More About Loan Prices Than Origination Processes

Share of respondents that favors each \$400, three-month loan

### Loan likely to be issued under the 5% payment option

If lenders reviewed customers' checking account histories and issued that loan for about \$60 in fees

79%

### Loan likely to be issued under the ability-to-repay process

If lenders pulled borrowers' credit reports, estimated their expenses, and issued that loan for about \$350 in fees

13%

Notes: Respondents were read the following statement: "Here are two possible outcomes of the proposed regulations for payday lending. Please tell me which of the two you would view as a better outcome for a \$400, three-month loan: If lenders pulled borrowers' credit reports, estimated their expenses, and issued that loan for about \$350 in fees; If lenders reviewed customers' checking account histories and issued that loan for about \$60 in fees." Results are based on 1,205 interviews. The order of these statements was randomized in the survey. Numbers shown do not total to 100 percent because "don't know" and "refused" responses were omitted.

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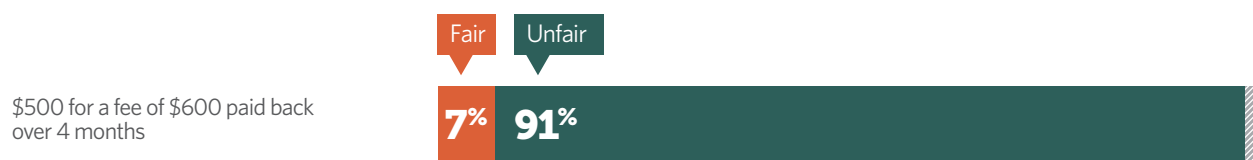
The CFPB's proposed rule focuses on establishing the process that lenders must use to originate loans, allowing those willing to comply with those guidelines to charge high prices and preventing lower-cost providers, such as banks and credit unions, from offering lower-cost loans at scale. If banks are permitted to issue loans using borrowers' checking account histories instead of the bureau's proposed ability-to-repay process, their pricing for small-dollar loans would be roughly six times lower than that of typical payday lenders. By a margin of 6 to 1, Americans prefer the loans that would be available from banks and credit unions under the CFPB's earlier 5 percent payment option to those that payday lenders would issue under the proposed ability-to-repay provision.

Figure 6

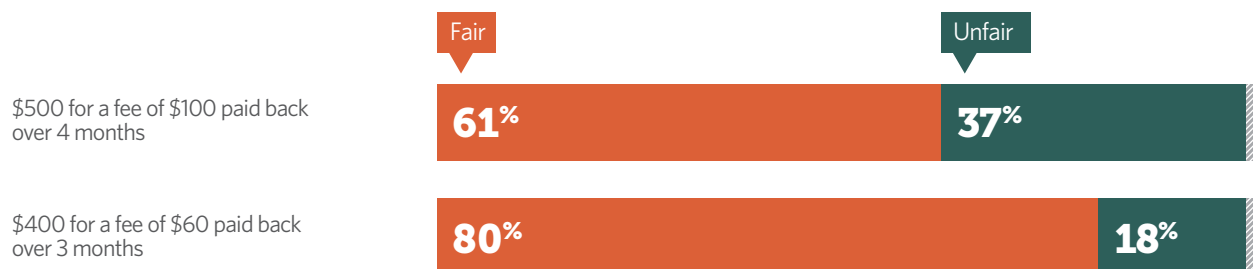
## Americans Say Payday Installment Loan Charges Are Unfair but That Planned Bank Small-Loan Prices Are Fair

Share of respondents, by loan type and terms

### Estimated pricing for ability-to-repay payday installment loans



### Estimated pricing for 5% payment bank small-dollar loans



Notes: Respondents were read the following statement: “Here are some examples of small loans that might be available to people who have low credit scores. For each, please tell me whether you think the terms seem fair or unfair. (Insert item.) Do you think the terms seem fair or unfair? a) \$500 for a fee of \$100 paid back over 4 months, so a person who borrows \$500 will pay back \$600; b) \$500 for a fee of \$600 paid back over 4 months, so a person who borrows \$500 will pay back \$1,100; c) \$400 for a fee of \$60 paid back over 3 months, so a person who borrows \$400 will pay back \$460.” Results are based on 1,205 interviews. The order of these statements was randomized in the survey. Numbers shown do not total 100 percent because “don’t know” and “refused” responses (indicated in gray) were omitted.

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Americans view current payday installment loans and those likely to be issued under the CFPB’s proposed ability-to-repay provision as unfair, but they say the loans that banks and credit unions plan to offer under the 5 percent payment option would be fair. Banks and credit unions have said they cannot take on the paperwork, compliance, and regulatory risk of the ability-to-repay process but are interested in offering small credit at lower prices with stronger safeguards under the 5 percent option.

Figure 7

## 3 in 4 Americans Say It Would Be Good if Banks Offered Small Loans, Even With Higher APRs Than Credit Cards

Percentage of respondents that agree

It would be a good thing if banks started offering small loans to their customers who use payday loans today because the prices would be six times lower than payday loans

77%

It would be a bad thing if banks started offering small loans to their customers who use payday loans today because the interest rates would be higher than credit cards

16%

Notes: Respondents were read the following statement: "Here are two views regarding small loans that banks might begin offering. Please tell me which of the two you agree with more. It would be a good thing if banks started offering small loans to their customers who use payday loans today because the prices would be six times lower than payday loans; It would be a bad thing if banks started offering small loans to their customers who use payday loans today because the interest rates would be higher than credit cards." Results are based on 1,205 interviews. The order of these statements was randomized in the survey. Numbers shown do not total 100 percent because "don't know" and "refused" responses were omitted.

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By a margin of almost 5 to 1, respondents said it would be a good thing if banks began offering small loans at prices six times lower than those of payday lenders, even if the rates would be higher than those for credit cards. All payday loan borrowers have a checking account because it is a loan requirement, so if these loans became available, they would be likely to replace a large share of high-cost loans.

## Methodology

On behalf of The Pew Charitable Trusts, Social Science Research Solutions conducted a nationally representative random-digit-dialing (RDD) telephone survey of 1,205 adults Aug. 12–21, 2016. The survey included an oversample of approximately 200 African-American and Latino respondents, which was weighted to match the demographic incidence of the RDD sample, producing an overall sample representative of the general population. The margin of error including the design effect is plus or minus 3.37 percent at the 95 percent confidence level. A detailed methodology is available at <http://ssrs.com/omnibus>.

## Endnotes

- 1 Proposed rule, 81 Fed. Reg. 47864 (July 22, 2016), <https://www.federalregister.gov/documents/2016/07/22/2016-13490/payday-vehicle-title-and-certain-high-cost-installment-loans>. For a summary of the proposed rule, see The Pew Charitable Trusts, “How the CFPB Proposal Would Regulate Payday and Other Small Loans: A Summary of the Draft Rule” (2016), <http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/09/07/how-the-cfpb-proposal-would-regulate-payday-and-other-small-loans>.
- 2 The Pew Charitable Trusts, “An Analysis of the Draft Rule: The CFPB’s Proposed Payday Loan Regulations Would Leave Consumers Vulnerable” (2016), <http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/09/07/the-cfpbs-proposed-payday-loan-regulations-would-leave-consumers-vulnerable>.
- 3 The Pew Charitable Trusts, “How CFPB Rules Can Encourage Banks and Credit Unions to Offer Lower-Cost Small Loans” (2016), <http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/04/05/how-cfpb-rules-can-encourage-banks-and-credit-unions-to-offer-lower-cost-small-loans>.
- 4 The Pew Charitable Trusts, “Payday Loan Customers Want More Protections, Access to Lower-Cost Credit From Banks” (2017), [www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/04/payday-loan-customers-want-more-protections-access-to-lower-cost-credit-from-banks](http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/04/payday-loan-customers-want-more-protections-access-to-lower-cost-credit-from-banks).
- 5 The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (October 2013), 12–16, [http://www.pewtrusts.org/-/media/legacy/uploadedfiles/pes\\_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf](http://www.pewtrusts.org/-/media/legacy/uploadedfiles/pes_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf).
- 6 Ian McKendry, “Banks’ Secret Plan to Disrupt the Payday Loan Industry,” *American Banker*, May 6, 2016, <http://consumerbankers.com/cba-media-center/cba-news/banks-secret-plan-disrupt-payday-loan-industry>; Consumer Financial Protection Bureau, *Small Business Advisory Review Panel for Potential Rulemakings for Payday, Vehicle Title, and Similar Loans: Outline of Proposals Under Consideration and Alternatives Considered* (March 26, 2015), [http://files.consumerfinance.gov/f/201503\\_cfpb\\_outline-of-the-proposals-from-small-business-review-panel.pdf](http://files.consumerfinance.gov/f/201503_cfpb_outline-of-the-proposals-from-small-business-review-panel.pdf).
- 7 Ibid.

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**For further information, please visit:**

[pewtrusts.org/small-loans](https://pewtrusts.org/small-loans)

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**The Pew Charitable Trusts** is driven by the power of knowledge to solve today's most challenging problems. Pew applies a rigorous, analytical approach to improve public policy, inform the public, and invigorate civic life.

# Appendix D





# Payday Loan Customers Want More Protections, Access to Lower-Cost Credit From Banks

Results of a nationally representative survey of U.S. borrowers

## The Pew Charitable Trusts

**Susan K. Urahn**, *executive vice president*

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## Acknowledgments

The project team thanks Steven Abbott, Esther Berg, Jennifer V. Doctors, David Merchant, Erika Pontarelli Compart, Mark Wolff, and Clifford Zukin for providing valuable feedback on the report, and Molly Mathews for production support. Many thanks to our other current and former colleagues who made this work possible.

## Overview

Payday loans typically carry annual percentage rates of 300 to 500 percent and are due on the borrower's next payday (roughly two weeks later) in lump-sum payments that consume about a third of the average customer's paycheck, making the loans difficult to repay without borrowing again. They are characterized by unaffordable payments, unreasonable loan terms, and unnecessarily high costs.

In June 2016, the Consumer Financial Protection Bureau (CFPB) proposed a rule to govern payday and auto title loans<sup>1</sup> that would establish a process for determining applicants' ability to repay a loan but would not limit loan size, payment amount, cost, or other terms. The CFPB solicited and is reviewing public comments on whether to include in its final rule alternatives to this process with stronger safeguards, particularly a 5 percent payment option that would limit installment payments to 5 percent of monthly income, enabling banks and credit unions to issue loans at prices six times lower than those of payday lenders, making lower-cost credit available at scale. An analysis by The Pew Charitable Trusts determined that the CFPB's proposal would accelerate a shift from lump-sum to installment lending but, without the 5 percent option, would shut banks and credit unions out of the market, missing an opportunity to save consumers billions of dollars a year.<sup>2</sup>

Previous Pew research found that payday loan borrowers want regulatory action to reform payday lending and expand lower-cost credit options, so in light of the CFPB proposal, Pew conducted a new nationally representative survey of 826 borrowers and found that:

- **70 percent of borrowers believe payday loans should be more regulated.**
- **Support for requiring installment payment structures is strong.** Three in 4 borrowers say having several months to repay and doing so in smaller installments would be major improvements, but most say additional underwriting would not.
- **Borrowers' priorities for reform include lower prices, affordable payments, and being able to obtain small loans from banks and credit unions.**
- **8 in 10 would prefer to borrow from a bank or credit union if they were equally likely to be approved, and 90 percent would do so if the loans cost six times less than those of payday lenders.** The pricing differential is based on payday lender fees for loans and on prices financial institutions would reportedly offer.

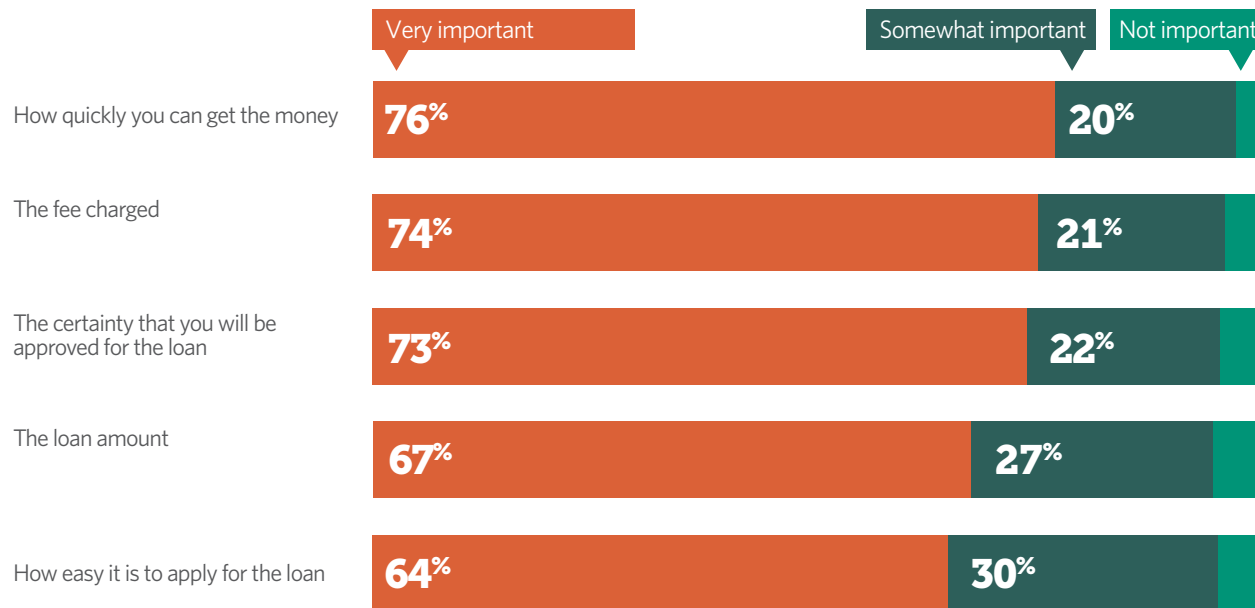
- **Virtually all would choose loans that cost six times less.** Ninety-two percent of borrowers say they would prefer the lower-cost credit that banks and credit unions would likely offer under the 5 percent payment option. Only 5 percent would opt for more expensive payday installment loans that went through the proposed ability-to-repay origination process.

These findings show that payday loan borrowers strongly favor reform and are especially supportive of steps that would encourage lower-cost bank and credit union loans. A separate survey of American adults found that the public shares these sentiments.<sup>3</sup> This chartbook discusses recommended changes to the proposal, including adoption of the 5 percent option, which is supported by Pew as well as many banks, community groups, and credit unions.

Figure 1

## When Deciding Where to Get a Loan, Borrowers Say Speed, Cost, and Certainty Are Top Factors

Percentage of respondents by loan characteristic



Notes: Respondents were asked: "In choosing where to get a payday loan, how important is the following to you? The fee charged; How quickly you can get the money; How easy it is to apply for the loan; The certainty that you will be approved for the loan; The loan amount." Then the respondents were asked: "You listed the following as "very important" when choosing to get a payday loan. Which one would you rank as the most important one?" Results are based on 826 interviews. Numbers do not total 100 percent because "refused" responses were omitted.

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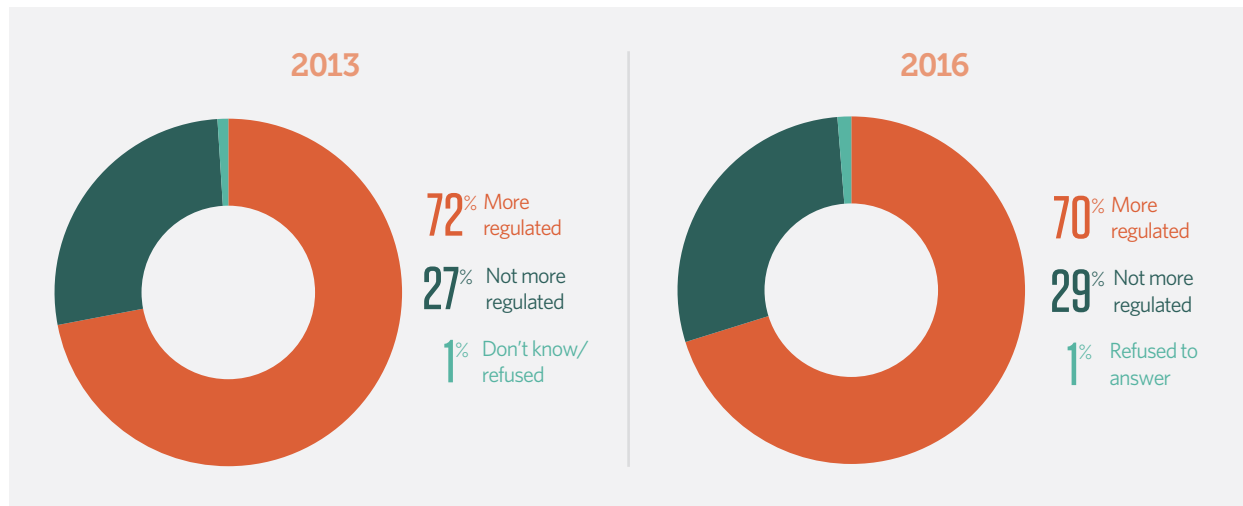
Those who cited multiple factors as "very important" were asked which was the most important. Thirty-nine percent chose "the fee charged"; 24 percent chose "how quickly you can get the money"; 21 percent chose "the certainty that you will be approved for the loan"; 11 percent chose "the loan amount"; and 6 percent chose "how easy it is to apply for the loan."

Figure 2

## As They Did Three Years Ago, 7 in 10 Borrowers Still Want Payday Loans to Be More Regulated

Percentage of respondents, 2013 and 2016

Roughly 12 million Americans use payday loans annually, spending an average of \$520 in fees to repeatedly borrow \$375.<sup>4</sup>



Notes: Respondents were asked: "Should payday loans be more regulated or not?" Results are based on 826 interviews.

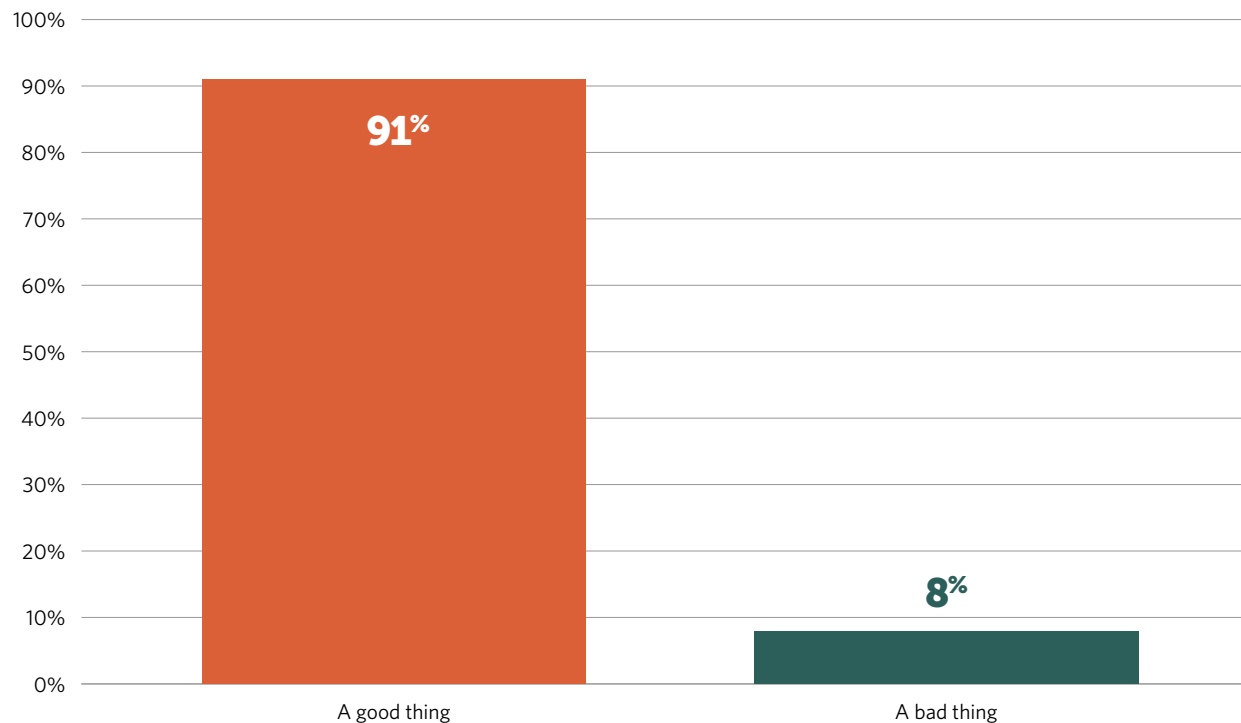
Source: The Pew Charitable Trusts, "Payday Lending in America: How Borrowers Choose and Repay Payday Loans" (2013), 48, [http://www.pewtrusts.org/~media/Assets/2013/02/20/Pew\\_Choosing\\_Borrowing\\_Payday\\_Feb2013-\(1\).pdf#page=48](http://www.pewtrusts.org/~media/Assets/2013/02/20/Pew_Choosing_Borrowing_Payday_Feb2013-(1).pdf#page=48)

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Figure 3

## 9 in 10 Borrowers Say Having Fewer Payday Loan Stores and Lower Prices Would Be a Positive Change

Percentage of respondents



Notes: Respondents were asked: "If some of the payday loan stores closed in your area, but the remaining stores charged less for loans, would that be a good thing or a bad thing?" Results are based on 826 interviews. Numbers do not total 100 percent because "refused" responses were omitted.

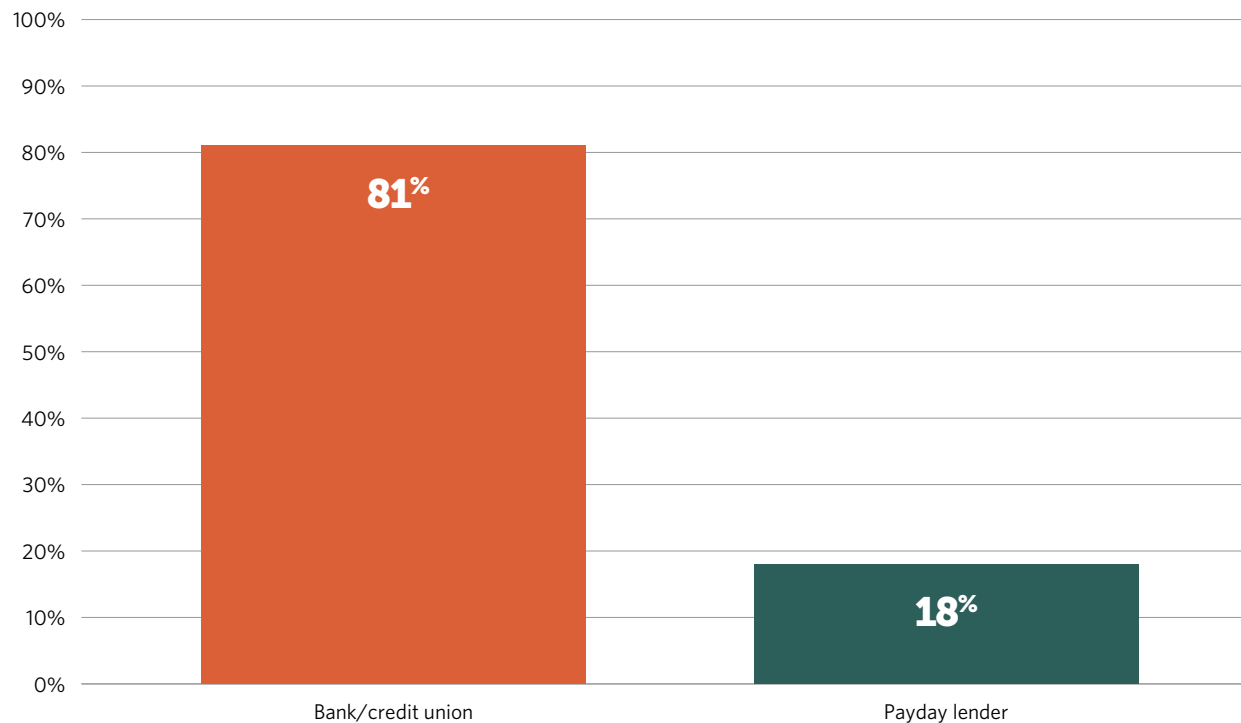
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In 2010, Colorado enacted a successful payday lending reform that led to the closure of more than half of payday loan stores over the ensuing five years but also doubled the number of customers served at each remaining store. The state required prices to be roughly three times lower than before the law changed, and lenders responded with improved efficiency. As a result, credit remains widely available, but loan payments now consume an average of 4 percent of a borrower's paycheck instead of the previous 38 percent. The reforms have saved Colorado borrowers more than \$40 million annually.<sup>5</sup>

Figure 4

## 8 in 10 Payday Loan Customers Would Prefer to Borrow From a Bank or a Credit Union

Percentage of respondents by lender type



Notes: Respondents were asked the following: "If you were equally likely to be approved for a small loan, would you prefer to borrow from a payday lender, or from your bank/credit union?" Results are based on 826 interviews. Numbers do not total 100 percent because "refused" responses were omitted.

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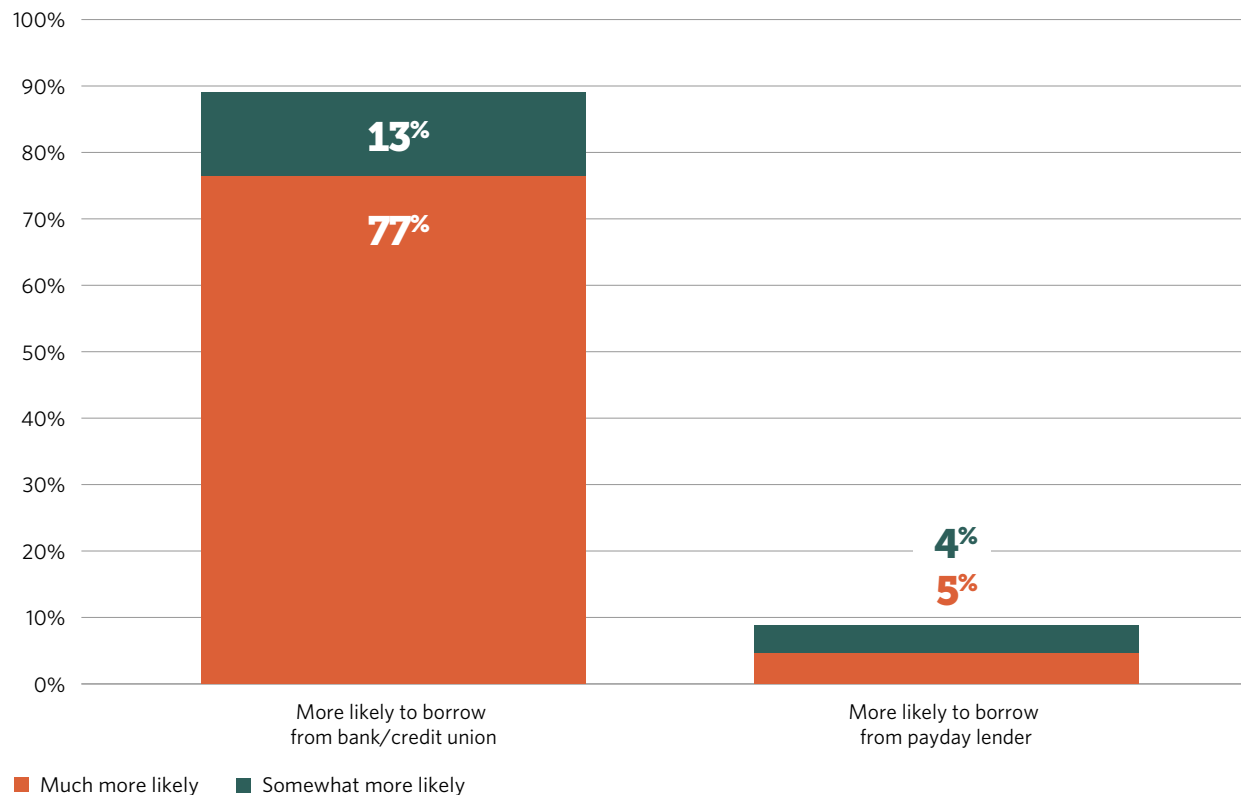
Every payday loan customer has a checking account at a bank or credit union because it is a loan requirement. Most customers would prefer borrowing from their bank or credit union instead of a payday lender as long as they were equally likely to be approved, but they cannot do so because regulatory uncertainty has made it difficult for banks and credit unions to issue small loans. Many financial institutions have expressed an interest in offering lower-cost, small-dollar credit to their customers who use payday loans, but only if they receive clear regulatory guidance that enables them to do so with simple underwriting.



Figure 5

## 9 in 10 Customers Would Borrow From Their Bank or Credit Union if Prices Were 6 Times Lower Than Payday Lenders'

Percentage of respondents by lender type



Notes: Pricing difference is based on published reports of banks' planned small-dollar loans. Respondents were asked: "Some banks and credit unions are considering offering a \$400 three-month loan with a \$60 fee. The same loan from a payday lender has a fee of about \$350. If you were looking to borrow a small amount of money, would you be more likely to borrow from your bank/credit union or more likely to borrow from a payday lender?" Results are based on 826 interviews. Numbers do not total 100 percent because "refused" responses were omitted.

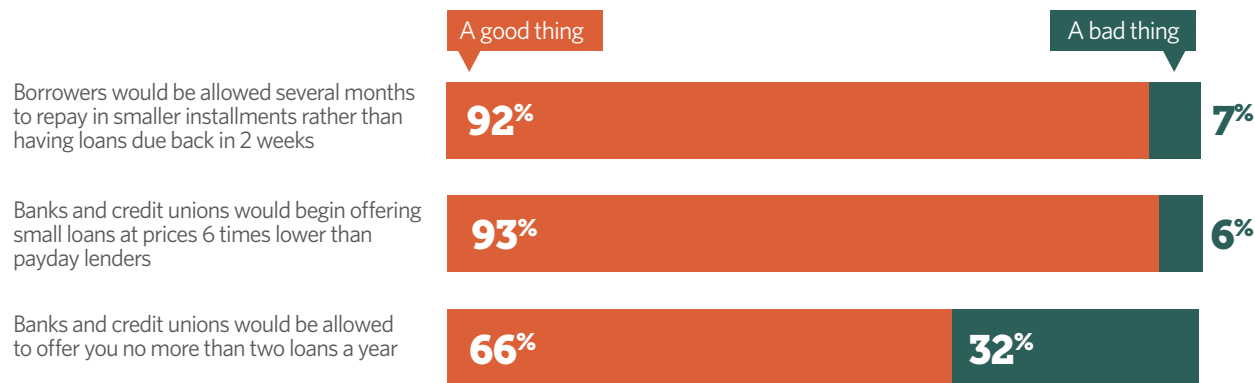
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In May 2016, *American Banker* reported that at least three large banks were planning to offer small loans, repayable in affordable installments, at prices that were roughly six times lower than those of average payday loans.<sup>6</sup> Given the choice, most borrowers say they would use these lower-cost bank or credit union loans rather than payday loans. Financial institutions have stated that they would not be able to offer such loans under the CFPB's proposed ability-to-repay (ATR) test but would under the 5 percent payment alternative. Several bank and credit union trade associations have asked the bureau to include the 5 percent payment option in the final rule.<sup>7</sup>

Figure 6

## Most Borrowers Say That Lower-Cost Bank Loans With More Time to Repay Would Be Good for Them

Percentage of borrowers by loan feature



Notes: Respondents were asked: “New regulations are being considered for payday loans. The next few screens are some situations that might result because of the new regulations. Please select whether you think it would be a good thing or a bad thing for you: Borrowers would be allowed several months to repay in smaller installments rather than having loans due back in 2 weeks; Banks and credit unions would begin offering small loans at prices 6 times lower than payday lenders; Banks and credit unions would be allowed to offer you no more than two loans a year.” Results are based on 826 interviews. The order in which these questions appeared was randomized in the survey. Numbers do not total 100 percent because “refused” responses were omitted.

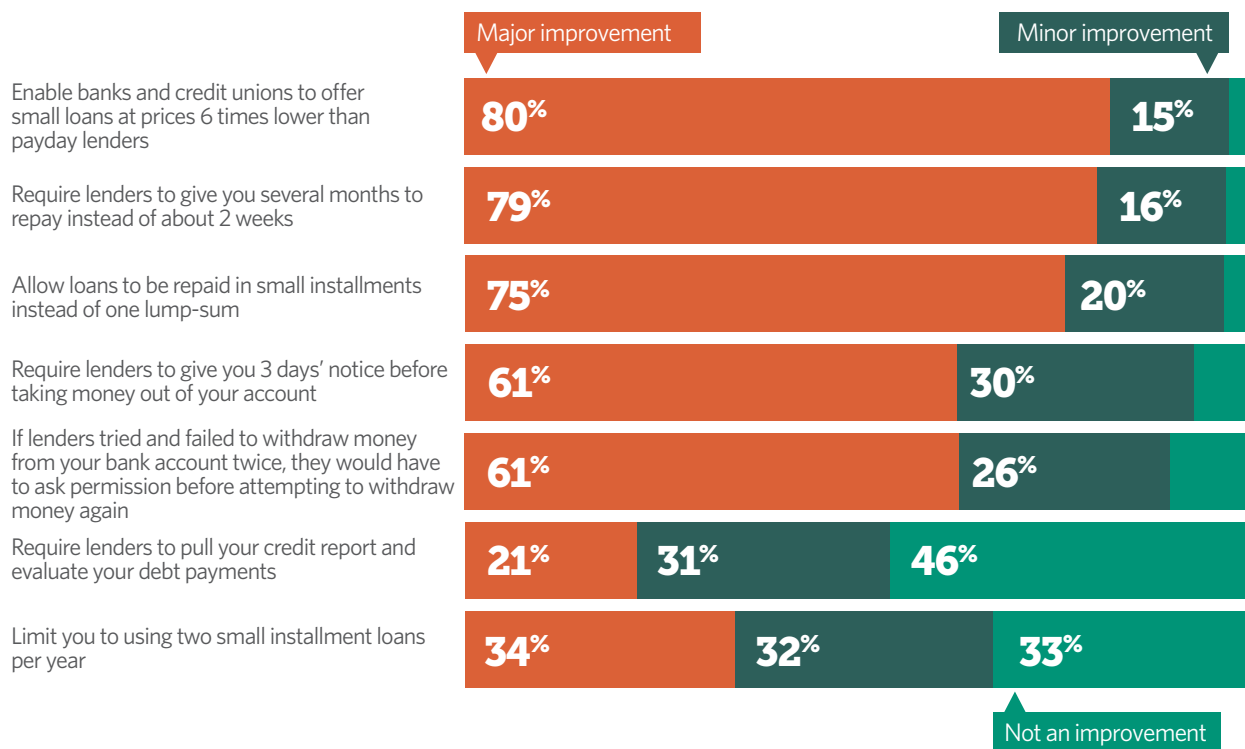
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If borrowers of high-cost credit were able to access loans from banks and credit unions that cost six times less than those offered by payday lenders, Pew estimates they would save more than \$10 billion annually, more than the United States spends on some major anti-poverty programs such as Temporary Assistance for Needy Families basic assistance and Head Start.<sup>8</sup> Borrowers reacted positively to the idea of banks and credit unions offering lower-cost small loans.

Figure 7

## Borrowers Say Lower Prices, More Time to Repay, and Smaller Payments Would Be Major Improvements

Percentage of respondents by potential regulation



Notes: Respondents were asked: "The next few screens are some steps regulators could take to help improve payday and other small loans. For each, please respond by selecting how much of an improvement you think it would be: a major improvement, a minor improvement, or not an improvement. a) Enable banks and credit unions to offer small loans at prices 6 times lower than payday lenders; b) Require lenders to pull your credit report and evaluate your debt payments; c) Require lenders to give you several months to repay instead of about 2 weeks; d) Require lenders to give you 3 days' notice before taking money out of your account; e) Allow loans to be repaid in small installments instead of one lump-sum; f) If lenders tried and failed to withdraw money from your bank account twice, they would have to ask permission before attempting to withdraw money again; g) Limit you to using two small installment loans per year." Results are based on 826 interviews. The order in which these questions appeared was randomized in the survey. Numbers do not total 100 percent because "refused" responses were omitted.

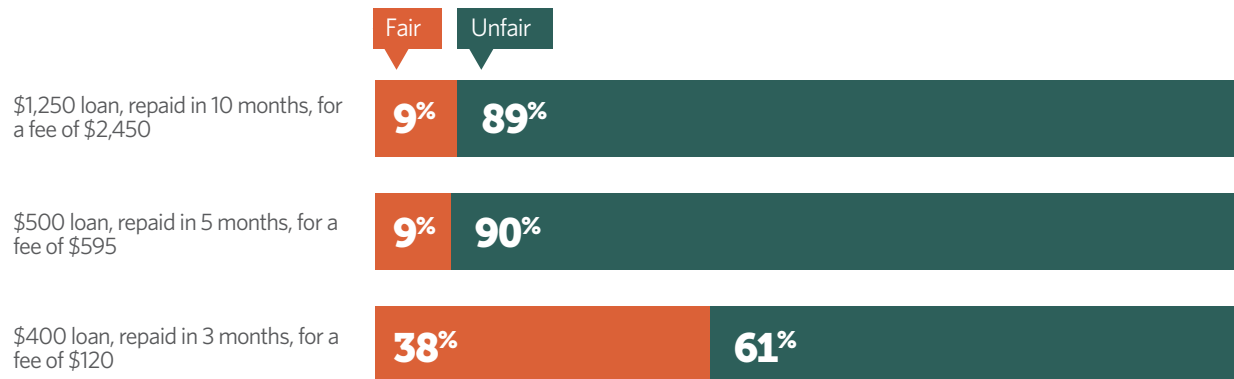
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When presented with possible components of the CFPB's final regulation, borrowers said loans with lower prices, more affordable payments, and reasonable installment structures would be a major improvement, but most said a debt evaluation process or a limit on the number of installment loans they could use was "not an improvement" or only a "minor improvement." The outcomes borrowers favored most were those that would probably result from the 5 percent payment option. The proposed rule relies heavily on a specific origination process that would make offering lower-cost installment loans at scale too difficult for banks and credit unions, but these institutions say they would be likely to offer such loans if the CFPB includes the 5 percent payment option in its final rule.

Figure 8

## Borrowers Say Current Payday Installment Loan Charges Are Unfair

Share of respondents by loan type and terms



Notes: Respondents were asked: "Here is a loan that payday lenders might offer under the new regulations. Please select if you think the terms are fair or unfair. a) A \$1,250 loan, repaid in 10 months, for a fee of \$2,450 (meaning you borrow \$1,250 and pay back a total of \$3,700); b) A \$500 loan, repaid in 5 months, for a fee of \$595 (meaning you borrow \$500 and pay back \$1,095); c) A \$400 loan, repaid in 3 months, for a fee of \$120 (meaning you borrow \$400 and pay back \$520)." Results are based on 826 interviews. The order in which these questions appeared was randomized in the survey. Loan A has an APR of 206 percent, while Loan B has an APR of 401 percent, and Loan C has an APR of 172 percent. Data do not total 100 percent because "refused" responses were omitted.

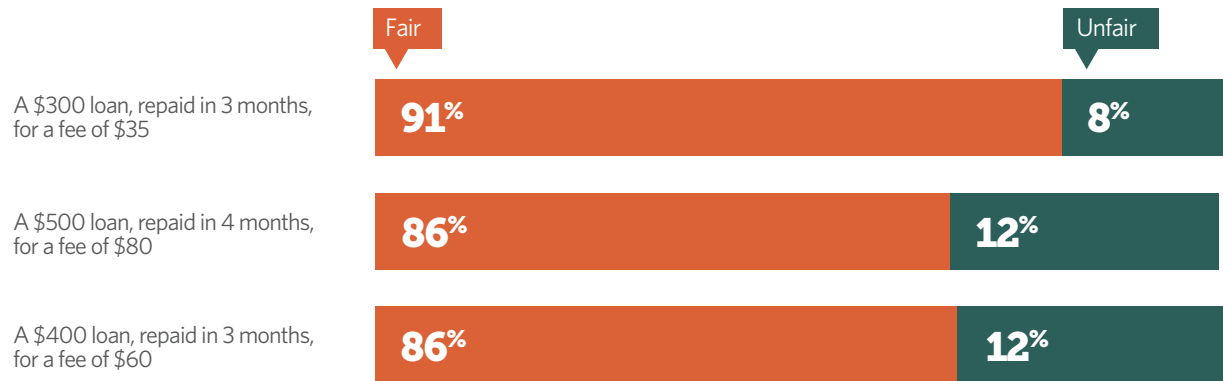
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Under the CFPB's proposed ATR provisions in which lenders would pull borrowers' credit reports, use a real-time database, and have an estimate of similar people's expenses, \$1,250 and \$500 loans, repayable in 10 and five months for \$2,450 and \$595 in fees, respectively, would probably continue to be offered. The bureau's commentary on the proposed rule stated that most payday installment loan borrowers would pass an ATR test for monthly payments of more than \$300, which is larger than the monthly payments for many payday installment loans and more than borrowers say they can afford.<sup>9</sup>

Figure 9

## Borrowers Say the Loans That Banks Would Be Likely to Offer Are Fair

Share of respondents by 5% payment option loans



Notes: Respondents were asked: "Here is a loan that banks might offer under the new regulations. Please select if you think the terms are fair or unfair. a) A \$300 loan, repaid in 3 months, for a fee of \$35; b) A \$500 loan, repaid in 4 months, for a fee of \$80; c) A \$400 loan, repaid in 3 months, for a fee of \$60." Results are based on 826 interviews. The order in which these questions appeared was randomized in the survey. Loan A has an annual percentage rate (APR) of 69 percent, while Loan B has an APR of 75 percent, and Loan C has an APR of 88 percent. Numbers do not total 100 percent because "refused" responses were omitted.

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Figure 10

## Payday Loan Customers Would Borrow From Their Banks if Loans Cost 6 Times Less

Percentage of borrowers by likely loan products

	Loan A	Loan B
Amount of loan	\$500	\$500
Cost of loan	\$125	\$750
Type of lender	Bank	Payday lender
Results	93%	5%

Notes: Respondents were asked: “The next few screens will show some small loans that last a few months and might be available to people who are looking to borrow money to pay an urgent bill. If you were looking to borrow a small amount of money, please mark whether you would choose Loan A or Loan B.” Results are based on 826 interviews. Numbers do not total 100 percent because “refused” responses were omitted.

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Banks and credit unions could offer five-month loans of \$500 for a \$125 fee under a 5 percent payment option, which borrowers say compare favorably to the \$500 loans with \$750 fees that payday lenders would be likely to issue under the proposed ATR provision. Unless the proposed regulations are modified, high-cost loans are the only ones likely to be widely available.

Figure 11

## Nearly All Borrowers Prefer Loans With Lower Prices and Simple Origination Processes

Percentage of borrowers by likely loan products

	Loan A	Loan B
<b>Amount of loan</b>	\$500	\$500
<b>Cost of loan</b>	\$75	\$450
<b>How the lender assesses whether you qualify</b>	Based on your checking account history, income, and history with the bank	Based on your credit report, income, and the lender's estimate of your expenses
<b>Results</b>	<b>92%</b>	<b>5%</b>

Notes: Respondents were asked: "The next few screens will show some small loans that last a few months and might be available to people who are looking to borrow money to pay an urgent bill. If you were looking to borrow a small amount of money, please mark whether you would choose Loan A or Loan B." Results are based on 826 interviews. Numbers do not total 100 percent because "refused" responses were omitted.

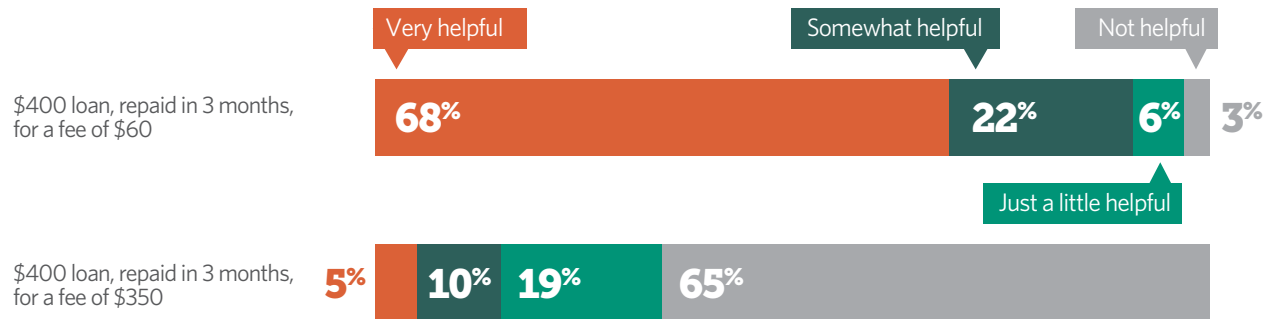
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If banks are allowed to issue loans under the 5 percent payment option using the borrower's checking account history and income information for underwriting purposes, they will be likely to offer a three-month loan of \$500 for \$75 in fees. Most borrowers would choose this loan over a \$500 loan with \$450 in fees that payday lenders would be likely to issue under the proposed ATR provision.

Figure 12

## Borrowers Say Cost Is Crucial to the Helpfulness of Small Loans

Percentage of respondents who say each loan is a benefit



Notes: Respondents were asked: "If you were short on cash, how helpful do you think the following loan would be? a) A \$400 loan, repaid in 3 months, for a fee of \$60 (meaning you borrow \$400 and pay back \$460); b) A \$400 loan, repaid in 3 months, for a fee of \$350 (meaning you borrow \$400 and pay back \$750)." Results are based on 826 interviews. The order in which these questions appeared was randomized in the survey. Numbers do not total 100 percent because "refused" responses were omitted.

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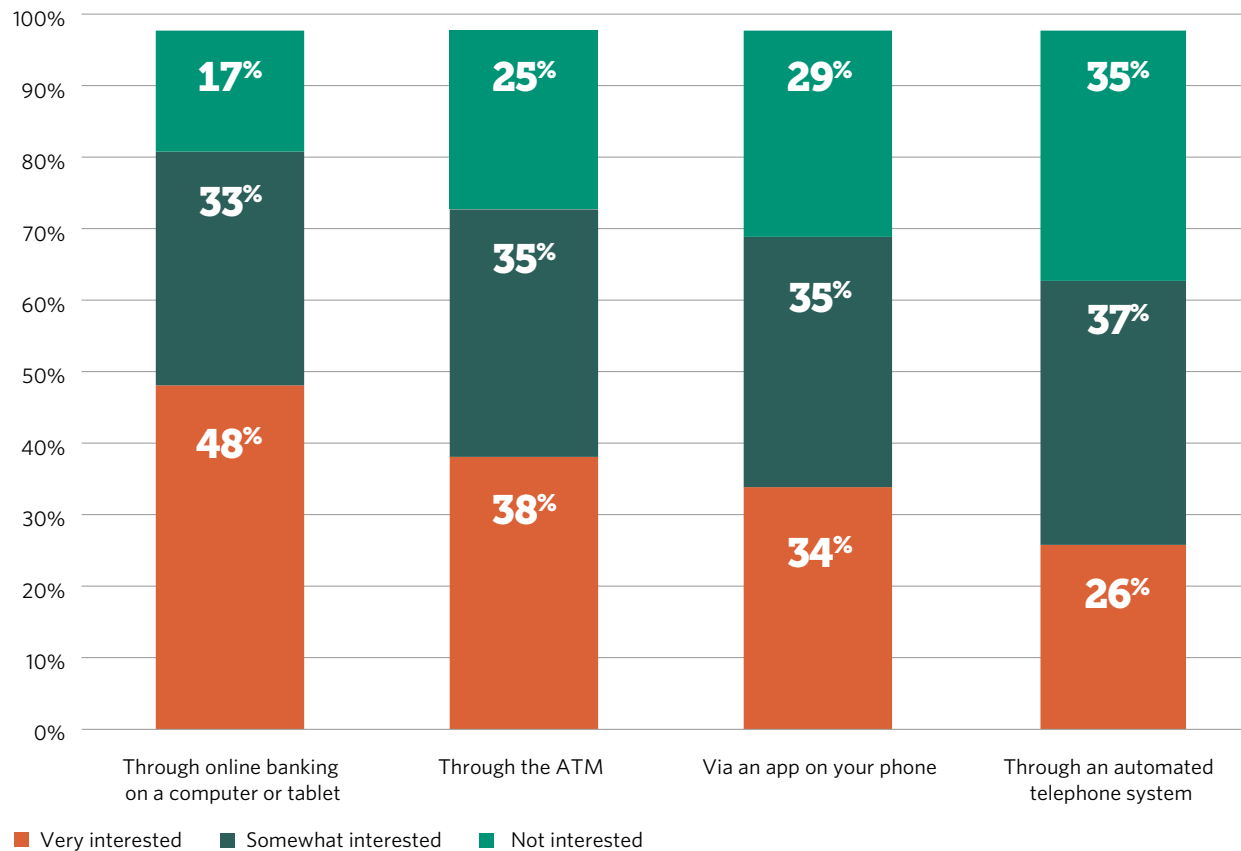
Advocates of payday loans frequently point to the help that readily available, small-dollar credit provides to borrowers when financial difficulties arise. And although borrowers agree that credit can be beneficial, they say cost is a major factor in determining whether loans are helpful. Banks would be likely to offer loans of \$400 for a fee of about \$60 if the 5 percent payment option is included in the CFPB's final rule, while payday lenders would charge fees of around \$350 for the same \$400 loan issued under the proposed longer-term ATR provision, meaning borrowers view the potential bank loans as far more helpful than payday installment loans. The bank loan with a \$60 fee would have an APR of 88 percent, compared with an APR of 473 percent for the payday loan.



Figure 13

## Borrowers Are Interested in Obtaining Bank Loans Electronically

Percentage of respondents by lending channel



Notes: Respondents were asked: "The next few screens are some ways that your bank could offer small loans. Please mark whether you would be very interested in obtaining a loan this way, somewhat interested, or not interested. a) Via an app on your phone; b) Through online banking on a computer or tablet; c) Through an automated telephone system; d) Through the ATM." Results are based on 826 interviews. The order in which these questions appeared was randomized in the survey. Numbers do not total 100 percent because "refused" responses were omitted.

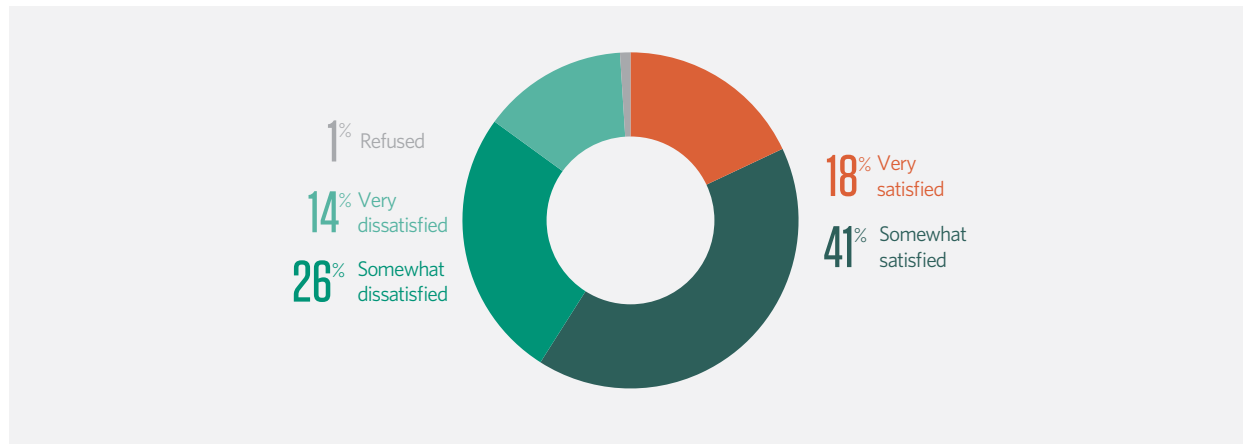
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Consumers are interested in obtaining loans through online banking and other channels. To keep costs down, banks would need to be able to issue loans using electronic and other automated methods that do not require staff time to process applications or disburse funds, but banks need clear standards to support such automation for lower-cost small-dollar loans. The ability to prescreen customers for eligibility, automate the origination process, and deposit proceeds immediately into checking accounts are the factors that would enable banks to profitably offer small loans at prices much lower than those of payday lenders.

Figure 14

## Borrowers Report Mixed Feelings About Current Loan Options at Their Bank

Percentage of respondents by satisfaction level



Notes: Respondents were asked: "How satisfied are you with your bank's loan options that are available to you today?"/"When you had a bank account, how satisfied were you with the bank's loan options that were available to you?" Results are based on 826 interviews. Numbers do not total 100 percent due to rounding.

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Figure 15

## Borrowers Responded Positively When Asked About Banks Offering Small-Dollar Loans

*Selected answers to “What would it say to you about your bank if they started offering small loans?”*

That the bank cares:

- It would say that my bank cares about me more than a payday lender.
- I would think that they are interested in helping people who are going through hard times.
- That they cared about average people.
- They care about their customers and are reasonable.

That the bank is fair and helpful:

- It says that my bank is interested in being fair.
- They are willing to help people who are experiencing difficulties.
- That the bank is trying to be helpful to middle- or lower-class families.
- That banks were finally trying to help people in need.

That borrowers can stop using payday loans:

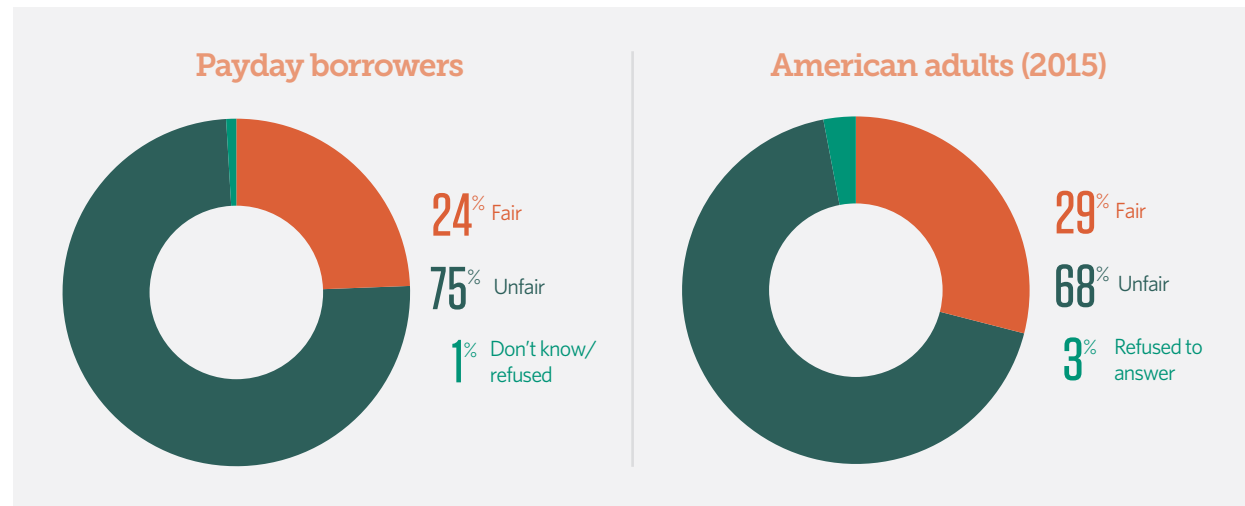
- That would be awesome. I would stop going to payday lenders.
- I would use that option before using an overpriced payday loan.
- It might help me finally get rid of my payday loan.
- That they are helping you get a small loan with a small fee, so the payday loans don't rip you off.

Note: Respondents were asked an open-ended question: “What would it say to you about your bank if they started offering small loans you could qualify for, repaid in a few months at a price six times lower than payday lenders?” Quotes were selected from among 826 interviews.

Figure 16

## 3 in 4 Borrowers and Most Americans See a \$35 Checking Account Overdraft Fee as Unfair

Percentage of borrowers and U.S. population



As shown in Figure 9 on Page 11, 9 in 10 borrowers see a \$35 fee for a \$300, three-month loan as fair, but 3 in 4 believe it is unfair to charge the same amount for a checking account overdraft. Current regulation does not support borrower preferences because it permits such overdraft fees but does not enable banks to offer lower-cost small-dollar loans at scale.

Notes: Respondents were asked: "Today, banks typically charge a fee of around \$35 for each overdraft. Do you think that's fair or unfair?" Results are based on 826 interviews.

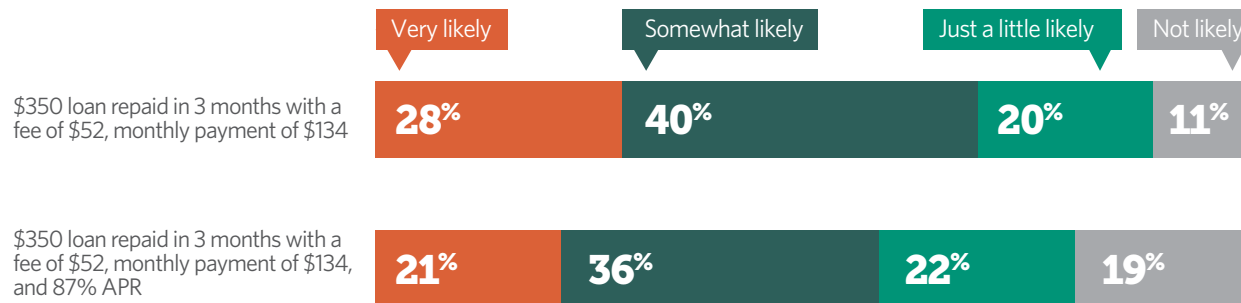
Source: The Pew Charitable Trusts, "CFPB Proposal for Payday and Other Small Loans: A Survey of Americans" (2015), 7, [http://www.pewtrusts.org/~media/assets/2015/07/cfpb\\_chartbook.pdf#page=9](http://www.pewtrusts.org/~media/assets/2015/07/cfpb_chartbook.pdf#page=9)

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Figure 17

## Most Payday Loan Borrowers Would Use Lower-Cost Bank Loans if Short on Cash

Percentage of respondents by loan product



Notes: Half of respondents were asked: "If you found yourself short on cash, how likely would you be to take this loan? \$350 loan repaid in 3 months with a fee of \$52, monthly payment of \$134." The other half were asked: "If you found yourself short on cash, how likely would you be to take this loan? \$350 loan repaid in 3 months with a fee of \$52, monthly payment of \$134, and 87% APR." Results are based on 826 interviews. Numbers do not total 100 percent because "refused" responses were omitted.

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Emphasizing annual percentage rate information does little to dissuade borrowing, deterring only about 1 in 10 respondents: When APRs are featured prominently, 57 percent of payday loan borrowers say they would be likely to use such a loan if short on cash, compared with 68 percent when APR is not highlighted.

## Methodology

On behalf of The Pew Charitable Trusts, the GfK Group conducted a national study of 826 payday loan borrowers Aug. 23-28, 2016. The survey was conducted using KnowledgePanel, a probability-based web panel designed to be representative of the United States. The survey consisted of two stages: initial screening for borrowers and the main survey with the study-eligible respondents. To qualify for the main survey, a panel member must have used a payday loan (at a store or online).

The margin of error including the design effect is plus or minus 4 percent at the 95 percent confidence level. A detailed methodology is available at <http://www.gfk.com>.

## Endnotes

- 1 Consumer Financial Protection Bureau, “A Proposed Rule for Payday, Vehicle Title, and Certain High-Cost Installment Loans,” June 2, 2016, <https://www.federalregister.gov/documents/2016/07/22/2016-13490/payday-vehicle-title-and-certain-high-cost-installment-loans>. For a summary of the proposed rule, see <http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/09/07/how-the-cfpb-proposal-would-regulate-payday-and-other-small-loans>.
- 2 The Pew Charitable Trusts, “How CFPB Rules Can Encourage Banks and Credit Unions to Offer Lower-Cost Small Loans,” (2016), <http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/04/05/how-cfpb-rules-can-encourage-banks-and-credit-unions-to-offer-lower-cost-small-loans>.
- 3 The Pew Charitable Trusts, “Americans Want Payday Loan Reform, Support Lower-Cost Bank Loans” (2017), [www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/04/americans-want-payday-loan-reform-support-lower-cost-bank-loans](http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/04/americans-want-payday-loan-reform-support-lower-cost-bank-loans).
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- 5 The Pew Charitable Trusts, “Trial, Error, and Success in Colorado’s Payday Lending Reforms” (2014), 6, [http://www.pewtrusts.org/~media/assets/2014/12/pew\\_co\\_payday\\_law\\_comparison\\_dec2014.pdf](http://www.pewtrusts.org/~media/assets/2014/12/pew_co_payday_law_comparison_dec2014.pdf).
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- 7 The Pew Charitable Trusts et al., group comment letter on the CFPB’s Notice of Proposed Rulemaking for Payday, Vehicle Title, and Certain High-Cost Installment Loans, Oct. 6, 2016, <https://www.regulations.gov/document?D=CFPB-2016-0025-142119>. The signatories on this letter include nonprofit leaders, credit counselors, researchers, and representatives of banks that collectively operate 1 in 6 bank branches in the United States.
- 8 Center on Budget and Policy Priorities, “How States Use Federal and State Funds Under the TANF Block Grant” (2015), <http://www.cbpp.org/research/family-income-support/how-states-use-federal-and-state-funds-under-the-tanf-block-grant>; U.S. Department of Health and Human Services, “Head Start Program Facts: Fiscal Year 2015,” last modified Feb. 8, 2017, <https://eclkc.ohs.acf.hhs.gov/hslc/data/factsheets/2015-hs-program-factsheet.html>.
- 9 The Pew Charitable Trusts, “Payday Lending in America: How Borrowers Choose and Repay Payday Loans” (2013), 13, [http://www.pewtrusts.org/~media/assets/2013/02/20/pew\\_choosing\\_borrowing\\_payday\\_feb2013-\(1\).pdf](http://www.pewtrusts.org/~media/assets/2013/02/20/pew_choosing_borrowing_payday_feb2013-(1).pdf); The Pew Charitable Trusts, “From Payday to Small Installment Loans” (2016), 7, [http://www.pewtrusts.org/~media/assets/2016/08/from\\_payday\\_to\\_small\\_installment\\_loans.pdf](http://www.pewtrusts.org/~media/assets/2016/08/from_payday_to_small_installment_loans.pdf); Consumer Financial Protection Bureau Proposed Rule, 12 CFR 1041 (2016), 48137–38.

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**For further information, please visit:**

[pewtrusts.org/small-loans](https://pewtrusts.org/small-loans)

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