SMALL-DOLLAR CREDIT AND FINANCIAL HEALTH: A POLICY PERSPECTIVE

For many years there has been intense interest among regulators, legislators, financial institutions and advocates with respect to the regulation of small-dollar credit products. These loans -- which typically must be repaid over a very short period of time -- are generally used by borrowers to meet immediate liquidity challenges. The predominant form of small-dollar credit in the United States are payday loans, although there also are small-dollar vehicle title loans, pawn loans, deposit advances, refund anticipation loans and installment loans. This Policy Perspective sets forth the Financial Health Network's position on the regulation of small-dollar credit in the context of recent market developments and ongoing regulatory interest.

Background

The regulatory and policy issues surrounding small-dollar credit have become all the more urgent in light of the severe economic dislocations resulting from the COVID-19 pandemic which are disproportionately affecting low- and moderate-income households. On March 28, 2020, less than two weeks after the President declared a national emergency, the federal banking regulators and the Consumer Financial Protection Bureau (CFPB) issued a Joint Statement Encouraging Responsible Small Dollar Lending in Response to Covid 19. Two months later, on May 20th, the banking agencies issued a set of Interagency Lending Principles for Offering Responsible Small-Dollar Loans and the following day the CFPB issued a Template No-Action Letter to the Bank Policy Institute which creates a streamlined process for Institute members and other depository institutions to obtain no-action assurances from the Bureau with respect to small-dollar credit products containing certain “guardrails” identified in the Template NAL.

At the same time, the CFPB continues to be actively considering its proposal to repeal the underwriting provisions of its 2017 Payday, Vehicle Title, and Certain High-Cost Installment Loan Rule (“2017 Payday Rule”). If the repeal proposal is finalized, those provisions -- which generally would require lenders making small-dollar loans to make a reasonable determination that the consumer has the ability to repay the loan without reborrowing before extending credit -- would not take effect as scheduled.

The Financial Health Network is the leading authority on consumer financial health and has undertaken extensive research to understand the financial lives of Americans, including research into the consumer behaviors, products, and providers that comprise the market for small-dollar credit. In light of these regulatory developments, as well as the current economic environment, Financial Health Network is issuing this Policy Statement. This statement is rooted in that research, as well as in Financial Health Network’s work with a wide range of financial institutions, from the largest national banks to innovative start-ups, that offer small-dollar credit.
The Position of the Financial Health Network

In brief, the Financial Health Network believes that:

● The demand for small-dollar credit is itself a symptom of the financial struggles too many families face and evidences the need for public and private actions that will enable these families to improve their financial health and minimize the demand for small-dollar credit. The current economic and health crisis has made that need even more urgent.

● Among households that are financially vulnerable or coping, there clearly are those that can benefit from well-structured small-dollar credit products as an occasional way to help with illiquidity. For households without other resources, such products have the potential to help them manage through a misaligned cash flow by bridging to the next paycheck or help them weather emergencies or other financial shocks. However, not all those who turn to small-dollar credit can benefit from it. In particular, for those whose expenses regularly exceed their income -- that is, who are “insolvent” rather than temporarily illiquid -- adding more debt to their balance sheet can only aggravate their already precarious situation.

● Because small-dollar credit can either advance or undermine the financial well-being of already-vulnerable households – and because market forces alone have proven to drive towards offering such credit indiscriminately – government has an important role to play in regulating the market for small-dollar credit to assure, at a minimum, that these products do not exploit those who are financially struggling and leave them worse off. Indeed, well-designed regulatory policies can stimulate the development of products that serve as stepping stones on borrowers’ journey to financial health.

● In order to advance the financial health of would-be-borrowers, small-dollar loans must be affordable. This means that small-dollar lenders should be required to engage in underwriting to assure that loans are structured and priced in such a way that borrowers have the ability to make the payments as they come due while still meeting basic needs and other financial obligations, and that would-be-borrowers whose expenses regularly outstrip their income are not saddled with more debt which will put them in a deeper hole. Lenders should not be free to treat any default rate, however high, as a cost of doing business and seek to cover those losses from high fees exacted from borrowers who cannot afford to repay a loan when due and consequently get caught in a cycle of prolonged reborrowing.

● APRs -- which by definition are an annualized cost -- are not necessarily the best measure of whether a small-dollar loan is affordable, especially for shorter-term loans. The Financial Health Network has encouraged policymakers to allow financial institutions to experiment
along the cost and availability spectrum, including for products with pricing above the traditional 36 percent cap on interest rates.

The Financial Health Network’s experience working with our network of financial service innovators – including traditional financial institutions, fintechs, nonprofits and community-based organizations – makes clear that it is entirely possible to build win-win small-dollar credit products which align sustainability for the provider with success for the borrower by integrating careful underwriting into small-dollar credit offerings. The choice between access and affordability is a false one, and regulators should not abandon their mission of protecting consumers in the name of allowing unfettered access to small-dollar credit.

Financial Health and Small Dollar Credit

Even before the current crisis – and notwithstanding a decade-long period of economic growth in which the US GDP grew by over 65 percent in nominal dollars – a sizable segment of Americans was still struggling to make ends meet. Numerous surveys have found, for example, that almost one in five households have expenses that regularly exceed their income,¹ and over two in five report worrying about,² and having difficulty paying,³ their bills.

Through the U.S. Financial Health Pulse – an annual, nationally-representative longitudinal survey of people in the U.S. which launched in 2018 – the Financial Health Network has developed in-depth data to better understand the totality of Americans' financial lives, including how people spend, save, borrow and plan.⁴ Our analysis of those data has found that under 30 percent of people in the U.S.

⁵ The Financial Health Network issued reports in 2018 and 2019 with the results of the prior year’s survey; the results from the 2020 study are forthcoming. This Policy Statement relies on those reports and on further analysis of the data collected through the Pulse surveys.
are financially healthy by which we mean that they are setting themselves up to be financially resilient and to be able to pursue opportunities over time. At the other end of the spectrum, almost one in five people are struggling with all, or nearly all aspects of their financial lives – a group we call “financially vulnerable.” In between are what we call the “financially coping,” who are struggling with at least some aspects of their financial lives.

Further, the Pulse has found that year over year, one in four people experience a material change in their financial health, divided almost equally between those for whom the change was positive and those for whom it was negative. Thus, over a two-year period, only one in four people fall consistently within the financially healthy group and an equal share of people are financially vulnerable in at least one year.

Not surprisingly, there are vast racial disparities in Americans’ financial health. For example, the 2019 Pulse found that the proportion of white individuals who were financially healthy was 2.4 times greater than black individuals (34 percent vs. 14 percent), while black individuals were 1.5 times more likely than white individuals to fall within the financially vulnerable tier (3 percent vs. 15 percent).

For the financially healthy, small-dollar credit is a non-issue. For example, the Pulse indicates that just a fraction of a percent of the financially healthy have taken out a payday loan or payday advance -- the most common form of small-dollar credit -- in the prior twelve months. In contrast, fully 10 percent of the financially vulnerable turn to payday loans in the course of a year. Indeed, the financially vulnerable, who represent under 20 percent of all individuals in any given year, comprise roughly 50 percent of all payday borrowers, with the remainder coming from the ranks of the financially coping. Moreover, small-dollar credit is a more pressing matter for minority households, who make up a disproportionate share of payday loan borrowers. For example, approximately 33 percent of Pulse respondents who said they or someone in their household took out a payday loan over 2018 and 2019 identified themselves as black. This is despite black households making up only 13 percent of total households, according to the United States Census Bureau.5

What this means is simply this: the demand for small-dollar credit is itself a symptom of the financial struggles too many families face. Regulation of small-dollar credit cannot change that fact – although other public policies can, and should, affect demand by enabling families to improve their financial health. But the design of small-dollar credit products -- and the regulatory framework governing them -- can at least assure that these products do not exploit those who are financially struggling and leave them worse off. Indeed, well-designed products and policies can even be a stepping stone on the journey to financial health.

5 Further research is needed to more accurately determine the share of minority households who turn to payday loans and other types of small dollar credit, as only a small number of all Pulse respondents took out payday loans.
The Financial Situation and Needs Cases for Small-Dollar Credit Borrowers

In 2012, when the CFPB first announced that it was examining small-dollar lending, Financial Health Network launched a multi-stage research initiative to understand small-dollar credit from the users’ perspective. Through that research, which combined in-depth interviews with a survey of more than 1,100 small-dollar credit borrowers, we identified three primary needs that drive consumers to obtain short-term, small-dollar credit:

- **Misaligned Cash Flow** – About one-third of borrowers turn to small-dollar credit because their rent, utility bill, car payment or other bill is due shortly before their next payday – or the day on which they could actually access funds from their next paycheck given the time it takes for deposits to clear under our slow-moving payment system. Although some fintechs have developed apps which enable employers to offer their employees the ability to obtain wages as they are earned without having to wait for payday, only a minority of employers have taken advantage of this functionality. As a result, families still can experience a misalignment in the timing of income and expenditures. Where cash flow is thus misaligned, short-term credit can bridge the gap and enable borrowers to stay afloat while waiting for access to their pay.

- **An Unexpected Expense** – Another roughly one-third of the borrowers turn to small-dollar credit to cover, or as the result of, an unexpected or emergency expense that puts a hole in the family’s budget. These expenses include home or car repairs, medical treatment, and helping out a family member or friend who needs money quickly. These borrowers use short-term credit to cover needs that could not easily be deferred or to pay bills that otherwise would have been covered by the money used for the emergency.

- **Exceeding Income** – The final group of borrowers have income that is regularly insufficient to cover their expenses. Juggling bills, they essentially turn to small-dollar credit to stave off one creditor and substitute another. For these households, borrowing can only exacerbate their plight by adding a further expense that they will need to deal with down the road.

These needs cases reflect the triggers that lead borrowers to seek out small-dollar credit. Underlying those needs cases, of course, is the borrowers’ financial fragility as the Pulse makes clear. As noted, payday borrowers come disproportionately from the ranks of the financially vulnerable but also from the ranks of those just coping financially. Most payday borrowers are living paycheck to paycheck (only one-quarter reported that their income exceeded their expenses in the prior year) with a

6 *Know Your Borrower: The Four Need Cases of Small-Dollar Credit Consumers* (2013), [https://s3.amazonaws.com/cfsi-innovation-files/wp-content/uploads/2017/01/26054909/Know-Your-Borrower-The-Four-Need-Cases-of-Small-Dollar-Credit-Consumers.pdf](https://s3.amazonaws.com/cfsi-innovation-files/wp-content/uploads/2017/01/26054909/Know-Your-Borrower-The-Four-Need-Cases-of-Small-Dollar-Credit-Consumers.pdf). At the time of this research, Financial Health Network was known as the Center for Financial Services Innovation. The research also included borrowers who took out installment loans of up to $5,000 and found that these products were used in distinct ways, with a significant segment of these borrowers using the loan for a planned purchase, often related to a house or small business.
substantial debt load (two-thirds reported having more debt than was manageable), and little in the way of savings (over 60 percent have under one month of expenses in liquid savings). Further complicating their situation, payday borrowers have limited if any ability to access mainstream credit: 85 percent of payday borrowers said they believe that their credit score is only fair or poor and over 40 percent overdraft their checking account three or more times in the course of a year. (Other research, using administrative data, has generally confirmed the accuracy of borrowers’ self-assessment of their creditworthiness.

Comparing payday borrowers with non-borrowers within the same financial tier further highlights how financially fragile these borrowers are. Even among those who fall within the group the Financial Health Network classifies as financially vulnerable, those who take out payday loans are especially financially fragile. For example, almost 90 percent of the financially-vulnerable payday borrowers report having less than one month’s worth of expenses in liquid savings and having more debt that is manageable and 82 percent report that they sometimes or often worry that their food will run out before their next paycheck; those figures are 12 percent to 26 percent higher than for financially-vulnerable households who are able to avoid resorting to using payday loans. Similarly, 90 percent of the financially-vulnerable payday borrowers report that their credit score is fair or poor, which is 25 percent higher than for the financially vulnerable households who do not use payday loans.

Among those who fall within the group Financial Health Network classifies as financially coping, the contrast between the payday borrowers and non-borrowers is even more stark: those who take out payday loans are almost twice as likely to have under a month’s worth of liquid savings (39 percent vs. 20 percent); are more than 1.5 times as likely to have more debt that is manageable (45 percent vs. 29 percent); are almost three times as likely to worry about having enough money for food (68 percent vs. 22 percent); and are 2.5 times as likely to report having a fair or poor credit history (63 percent vs. 25 percent).

In short, while there are a variety of reasons that cause consumers to turn to small-dollar credit, they share in common a pressing need that the household cannot meet through savings or mainstream credit options.

**Implications for the Regulation of Small Dollar Credit**

The findings discussed above about the state of financial health in the United States should be a call to action for policy makers concerned with advancing the financial well-being of Americans. To repeat: the demand for small-dollar credit is itself a symptom of the financial struggles too many

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families face and there is a pressing need for policies that address the underlying causes. But so long as there are so many financially vulnerable and coping families seeking small-dollar credit products, government also has an important role to play in ensuring that these products do not take unreasonable advantage of these consumers and exacerbate their struggles.

In particular, there are three implications from the research into the financial health of those who may seek small-dollar credit, and the needs cases underlying their usage, that should inform government’s response.

First, there clearly are households that need, and can benefit from, well-structured small-dollar credit products. For households without other resources, such products have the potential to help them manage through a misaligned cash flow by bridging to the next paycheck or help weather emergencies or other financial shocks.

Second, the need for small-dollar credit does not necessarily imply a need for short-term credit; those are distinct issues. For some households facing a misaligned cash flow, a short-term product may suffice to meet that need. However, households facing financial shocks rarely are able to recover in two or even four weeks so that products designed to require rapid repayment of the full amount borrowed and accrued finance charges are likely to produce financial pain when payments come due. The mismatch between the needs of these borrowers and the short-term balloon structure of traditional payday loans may explain why upwards of one-quarter of payday loan borrowers end up borrowing ten or more times in succession before finally paying off their loans. These borrowers account for more than half of all payday loans.8

Third, not all those who turn to small-dollar credit can benefit from it. In particular, for the roughly one-third of borrowers whose expenses regularly exceed their income -- those who are for all intents and purposes insolvent — adding more debt to their balance sheet can only aggravate their already precarious situation. These borrowers may fall within the group of what has been termed “persistent” payday borrowers — borrowers who have been observed, over a period of four years, to have had payday loans at least half the time, some of who had payday loans outstanding for the entire four years.9 They may also be among the sizable group of borrowers who almost immediately default, placing themselves at the mercy of debt collectors.10

9 nonPrime101, A Balanced View of Storefront Payday Borrowing Patterns: Results from Longitudinal Random Sample Over 4.5 Years (March 2016), file:///C:/Users/dsilb/Downloads/7-C-A-Balanced-View-of-Storefront-Payday-Borrowing-Patterns-3.281%20(3).pdf
10 CFPB, Supplemental Findings.
Because small-dollar credit can either advance or undermine the financial well-being of already-vulnerable households – and because market forces alone will drive towards offering such credit indiscriminately – the Financial Health Network has long believed that government has an important role to play in regulating the market for small-dollar credit. We have observed that many of the products in that market both exploit and perpetuate borrowers' financial distress. And we have argued as a core principle that small-dollar loans should be affordable. This means that the loan must be structured and priced in such a way that the borrower has the ability to make the payments as they come due while still meeting basic needs and other financial obligations; it also means would-be-borrowers whose expenses regularly outstrip their income should not be saddled with more debt which will put them in a deeper hole.

Assuring that loans are affordable in turn means that lenders should be required to invest in underwriting capabilities, rather than essentially treating any default rate, however high, as a cost of doing business. Absent careful underwriting, lenders inevitably will seek to cover soaring losses with high fees exacted from borrowers caught in a cycle of prolonged reborrowing because they cannot afford to repay their loan when due. The Federal Reserve Board mandated ability-to-repay underwriting for subprime mortgages in 200811 and Congress has since expanded that requirement to all residential mortgages12 and consumer credit cards13. The same principle should apply to those making small-dollar loans as well.

Traditionally, the tool that has been used to regulate small-dollar credit has been price regulation. Since around the turn of the last century, that has taken the form of a usury limit of a 36 percent Annual Percentage Rate (APR) for small-dollar loans. But while some price regulation may be useful to limit the opportunity for exploitive behavior – for example, several states have enacted a novel approach, capping the total interest and fees that can be charged on a small-dollar loan at a fixed percentage of the loan amount14 – regulating annual costs is an inherently imprecise regulatory tool, especially for smaller and shorter-term loans. Take, for example, a fully amortizing, three-month $300 loan at a 36 percent APR; such a loan, if repaid when due, would produce less than $20 of income for the lender. That may not be sufficient to cover the expenses in originating and servicing the loan or the lender’s cost of funds, let alone the cost of defaults. At the very least, such a price control may limit lenders’ ability to take on risk, and thus to serve those consumers who have a need which could be met by a fairly priced small-dollar credit product. Accordingly, the Financial Health Network has encouraged policymakers to allow financial institutions to experiment along the cost and availability spectrum, including for products with pricing above 36 percent APR.

12 15 USC § 1639c.
13 15 USC § 1665e.
Importantly, the Financial Health Network’s work with our network of financial service innovators – including traditional financial institutions, fintechs, non-profits, and community-based organizations – makes clear that it is entirely possible to build win-win small-dollar credit products. These products are sustainable for the provider while furthering the financial health of borrowers by integrating careful underwriting into small-dollar credit offerings. In the age of digitization and machine learning, underwriting can be done both efficiently and effectively. Indeed, recent research has demonstrated the predictive validity of “cash flow underwriting” which looks to transactional history from checking or prepaid debit card accounts to verify income and examine cash outflows relative to deposits and which allows for underwriting of those without a traditional credit file.\footnote{FinRegLab, The Use of Cash-Flow Data in Underwriting Credit: Empirical Research Findings (July 2019), https://finreglab.org/wp-content/uploads/2019/07/FRL_Research-Report_Final.pdf} These data are readily available to banks and credit unions and, with the applicant’s consent, can be seamlessly transmitted to other lenders as well.

The best proof that responsible small-dollar lending is feasible is that it exists today. For example, in 2018, U.S. Bank introduced Simple, a three-month, installment loan product based on careful underwriting criteria including a limitation on loan size so that payments are manageable given the customer’s monthly income. And while Simple represents something of a breakthrough for large-bank involvement in this space, a number of fintechs such as Oportun and Petal are dedicated to developing and offering underwritten, small-dollar credit products in which the lenders’ and borrowers’ interests are aligned. In short, we have no doubt that small-dollar lending and responsible underwriting can go hand in hand.

Recent Regulatory Developments

As previously noted, the federal banking regulators recently issued a set of Interagency Lending Principles for Offering Responsible Small-Dollar Loans. Those principles are, in the main, consistent with the Financial Health Network’s policy perspective. The principles recognize that responsible lending is characterized by a “high percentage of consumers successfully repaying their small dollar loans in accordance with original loan terms” -- thereby “minimiz[ing] adverse consumer outcomes, including cycles of debt due to rollovers or reborrowing” -- and by “outcomes and program structures that enhance a borrower’s financial capabilities.” To achieve those ends, the principles focus on “loan structures,” “loan pricing” and “loan underwriting” along with “loan marketing and disclosures” and “loan servicing and safeguards.”

Similarly, the “guardrails” for depository institutions to follow in seeking no-action assurances under the CFPB’s recent Template No-Action Letter include provisions for fully amortizing loans with a minimum term of 45 days (although with an unexplained and potentially problematic exception for
draws of up to $250 on an open-end line of credit), underwriting using transaction activity, and a prohibition on rollovers or on reborrowing to repay an existing balance, among other safeguards. The Financial Health Network agrees that these guardrails are important elements in defining responsible small-dollar credit products.

In contrast, the CFPB’s proposal to repeal the underwriting provisions of the 2017 Payday Rule represents a major step backwards. In 2016, when the Bureau proposed a rule that would require lenders offering short-term credit to make a reasonable determination of borrowers’ ability to repay without reborrowing, the Financial Health Network submitted a comment supporting the principle underlying that proposal. In 2019, when the Bureau proposed to repeal the 2017 Payday Rule, the Financial Health Network submitted a comment opposing the proposed rescission as an “unjustified abandonment of core provisions of the final rule – particularly the ability to repay requirement.” The Financial Health Network continues to believe that repeal would be a giant step backwards, especially in these challenging times.