FINANCIAL HEALTH NETWORK

INDUSTRY INSIGHTS

How Financial Institutions Can Structure Small-Dollar Credit for Financial Health

In response to the COVID-19 crisis, federal banking regulators have issued a series of policy statements encouraging, and defining principles for, "responsible" small-dollar lending. While there is no universally accepted bright-line definition of small-dollar credit, these are generally loans of under $1,000 used by borrowers to meet immediate liquidity challenges and typically must be repaid over a very short period of time, such as 30 days or less. At the same time, the Consumer Financial Protection Bureau (CFPB) has rescinded the mandatory underwriting provisions of its 2017 Payday Rule, thus removing the legal obligation to assess borrowers' ability to repay. Financial institutions considering entering the small-dollar credit market thus face a range of choices in developing their products.

The Financial Health Network is issuing these recommendations to guide financial institutions interested in serving the small-dollar credit needs of consumers in a way that furthers their financial health. Because an important element of financial health is resilience – that is, the ability to withstand financial shocks – it follows that the need for small-dollar credit is itself often a symptom of a customer in poor financial health. As financial institutions consider how they can meet the immediate credit demands of these customers, the Financial Health Network encourages these institutions to also think about developing – and measuring the effectiveness of – programs designed to minimize the need for such credit by helping consumers reduce their expenses and pay down their credit card debt to build a savings buffer and a credit card safety valve.

With respect specifically to small-dollar credit, the Financial Health Network published "The Compass Guide to Small-Dollar Credit" in 2014 after consulting with a wide range of advisors in financial services, consumer advocacy, and academia. This guide provides a set of best practices for high-quality small-dollar credit. These guidelines – which cover the full product lifecycle, from marketing through customer service and collections – remain our compass for charting a path toward creating mutually beneficial products that promote success.

As financial institutions consider their next steps in the wake of the economic crisis and recent regulation, we offer the following concrete recommendations to guide them in developing the core elements of their small-dollar credit offerings:

Structure Affordable Payments: An affordable payment is one that the borrower can make and still meet other obligations and cover basic living expenses. Three factors determine the size of the payments: the amount of the loan, the loan term, and the finance charges. There are inherent tensions in balancing among these factors. For example, all else being equal, longer terms will drive payments down but will also increase the risk of default for the lender and the total cost to the consumer. In the Financial Health Network's view, there is not a single "right" balance, and small-dollar credit programs need to be carefully designed to assure that they optimize the needs of the borrower and are sustainable for the lender. Importantly, what is affordable will vary from borrower to borrower based upon their individual financial situations, so that affordability requires focusing both on product structure and individual borrower circumstances.

Avoid Short-Term Balloons: In principle, there may be some borrowers – especially those who turn to small-dollar credit because of a temporary misalignment between the timing of their income and payment obligations – who can afford to repay a small-dollar loan in a single balloon payment. But many borrowers turn to small-dollar loans because of an unexpected expense or drop in income, and these borrowers are unlikely to recover from that financial shock in a period of weeks. Identifying borrowers at the point of application who can afford to repay a small-dollar loan in a single payment is challenging at best, and the consequences of misjudgments can be severe. Therefore, the Financial Health Network believes small-dollar credit products should be amortizing ones, ideally with minimum terms of 60 or 90 days.

Underwrite to Screen Out Those Without the Ability to Repay: Our research has established that while some consumers turn to small-dollar credit to deal with a misalignment of income and expenses or to cope with a financial shock, roughly a third of borrowers have expenses that regularly outstrip their income. Appropriately structured small-dollar credit can help consumers in the first two groups. But for consumers in the third group – the insolvent, as distinguished from the illiquid – saddling them with more debt is likely to end badly either for the consumer, the lender, or both. The Financial Health Network thus does not believe that small-dollar credit programs should be designed with the goal of maximizing approvals or on the assumption that every consumer can afford to take on some amount of additional debt. Rather, we believe such programs should be designed to avoid compounding the problems of those who already cannot handle their existing obligations by examining would-be borrowers' income and expenses. As noted by regulators in their most recent guidance, advances in the evaluation of cash flow data can be used to screen for insolvent applicants.

Supplant, Rather Than Supplement, Overdraft: The notion that banks have been absent from the small-dollar credit market is a myth. In truth, banks are the largest suppliers of small-dollar credit in the form of automated overdraft programs. Indeed, many borrowers report turning to small-dollar loans to avoid the steep, per-transaction cost of overdrafting. Yet frequently, borrowers who obtain small-dollar loans are also overdrafters; for example, the CFPB's study of deposit advance products (DAP), a short-term line of credit that several financial institutions offered and which required each advance to be repaid out of the next deposit, found that two-thirds of borrowers were also overdrafters and that overdraft usage increased with DAP usage. The Financial Health Network's analysis of data from its 2019 Financial Health Pulse Survey reveals that roughly 75% of payday borrowers are also overdrafters. We believe that any small-dollar credit program needs to be designed as a substitute for, rather than an addition to, overdraft as a means of dealing with liquidity challenges.

Build Resilience for the Long Term: As noted at the outset, the need for small-dollar credit is itself often a symptom of a deeper problem. Inquiries for small-dollar credit thus can also serve as an opportunity for broader engagement with consumers to reduce reliance on these products and increase overall financial health. The business case is clear: Increased investment in consumer financial health results in greater profitability, higher loyalty and retention, and greater customer share of wallet. This is also confirmed by the industry: A survey of senior executives at a variety of financial institutions, including banks, credit unions, and fintechs, showed nearly 70% said improving customer financial health was a top business priority. A suite of products built for improving financial health is not only an acute need, but crucial in a competitive market.

In addition to our research in the space, the Financial Health Network has consulted for a number of organizations on matters related to small-dollar credit, including product design and gap assessments that address the recommendations outlined in this brief. We look forward to working with our Members, and others interested in offering responsible small-dollar credit, to develop programs that further the financial health of those who are financially vulnerable.

Please visit our Credit Research page for related research and news, or contact Josh Sledge at jsledge@finhealthnetwork.org to learn about how we can best support you.

