

**Incentivizing Responsible Small-Dollar Lending
in Low-Income Communities**

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EXECUTIVE SUMMARY

POLICY QUESTION

“Based on results of pilot programs and policies implemented in other parts of the country, how can cities and states best support and incentivize responsible small-dollar lending in low-income communities?”

RECOMMENDATION

Design a borrower’s card system to collect information about consumers’ borrowing and repayment behaviors, to encourage lenders to extend loans to low-income individuals in need, and to incentivize consumers to take ownership of their own financial behavior.

PROBLEM STATEMENT

In many states, the payday lending market has operated to meet the strong consumer demand for short-term small-dollar loans. In the realm of small-dollar lending, the payday lending market provides access for low-income individuals who might be classified as higher risk consumers, likely due to blemished credit histories. Lenders compensate for this higher risk by charging a higher interest rate, which would allow for the possibility that the borrower does not repay the loan. However, though the payday lending market is competitive, significant information asymmetries exist for both the lender and the borrower, which leave lenders unable to discern between high-risk and low-risk consumers, and leave borrowers with an unclear understanding of the terms of the loans and often, with increased amounts of debt.

The reliance on payday loans poses significant problems for borrowers, however. Research has shown that consumers often are unable to repay within a single pay period and thus have to roll over their loan for another borrowing period, and accrue another fee. Therefore, for many borrowers, what starts off as a short-term loan turns into long-term payments because of rollover and chronic borrowing patterns. Furthermore, within the industry, only a few states seem to have a standardized database housing information on borrowing and repayment history for payday loan consumers. The lack of a centralized system makes it difficult to keep track of where consumers are originating their loans, how often they are taking out payday loans, and their true ability to repay.

More responsible loan programs are characterized by a variety of criteria to ensure access to credit without trapping borrowers in additional debt. These characteristics include annual percentage rate caps, extended loan terms, multiple installment payment plans, proper underwriting of loans based on a borrower’s ability to repay, and financial counseling or a savings component. The tension in designing an alternative program is in balancing consumer need and incentive, market failures in information asymmetries, and business profitability concerns in order to meet the demand for these loans while not encouraging or incentivizing unscrupulous or predatory behavior.

CRITERIA

The following criteria are used to analyze each alternative proposed below.

- **Minimize risk associated with consumers' ability to repay loans:** This criterion aims to reduce the risk associated with a consumer's ability to repay by either better assessing consumer riskiness or ensuring that whatever consumer risk does exist does not prohibit or limit the potential for the loan to be repaid.
- **Provide incentive for lenders to make loans with a positive expected value:** A viable alternative will provide the incentive for lenders to rationally extend a loan by reducing consumer risk, allowing lenders to better examine consumer risk, or by guaranteeing that they will be compensated for the risk associated with the population they are serving.
- **Provide incentive for consumers to improve behavior:** A viable alternative should provide a mechanism by which consumers choose to improve their own repayment behavior, in order to ensure lenders receive the return on the loans that they make and continue to provide access to the small-dollar loans.
- **Maximize sustainability of program implementation:** Any recommended program design should consider factors of sustainability, such as cost considerations, simplicity of implementation, political pushback, or scalability concerns.

ALTERNATIVES

The following alternatives provide plausible program designs for a responsible small-dollar lending program. Each alternative is weighted against the specific criteria identified above.

- 1) Use a referral process to provide loans to approved low-income and/or high-risk consumers.
- 2) Design a borrower's card system to collect information about consumers' borrowing and repayment behaviors.
- 3) Fund a loan loss reserve pool to back loans made to low-income and/or high-risk consumers.

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POLICY QUESTION

The policy question addressed in this report is:

“Based on results of pilot programs and policies implemented in other parts of the country, how can cities and states best support and incentivize responsible small-dollar lending in low-income communities?”

PROBLEM STATEMENT

In many states, the payday lending market has operated to meet the strong consumer demand for short-term small-dollar loans.¹ The industry is “highly fragmented”² and generally consists of many small firms who offer these loans to borrowers contingent upon repayment of the loan plus an interest rate and additional fees by the borrower’s next payday. Minimal barriers to entry make the industry competitive in nature.³ However, significant information asymmetries exist for both the lender and the borrower, which leave lenders unable to discern between high-risk and low-risk consumers, and leave borrowers with an unclear understanding of the terms of the loans and often, with increased amounts of debt.

Payday loans are short-term, small-dollar loans for cash that are secured by authorized access to an individual’s bank account on an agreed-upon date.⁴ Generally, an individual writes a post-dated personal check to a lender or authorizes electronic access to their bank accounts for the amount of their desired loan (generally less than \$500) plus a transaction fee (typically ranging from \$15 to \$22 per \$100 borrowed).⁵ The lender holds the check until an agreed-upon date (typically their next payday), at which point the borrower has the option to repay their loan and fee or allow the lender to deposit the check.⁶ In the case that consumers are unable to repay their loan in full, borrowers either face potential insufficient funds or overdraft fees, roll over their loan for an additional fee, or take out additional loans to pay back the first loan.⁷ The post-dated check serves as a low-cost form of collateral for lenders.⁸

Data suggest that payday lenders are perceived to be “the best way to meet an immediate need for a cash advance of \$100 to \$500.”⁹ Research has shown that payday loans are typically taken out for convenience, to cover an emergency, or to pay for consumption needs.¹⁰ Generally, low-

¹ Plunkett and Hurtado, “Small-Dollar Loans, Big Problems”, p. 31-32

² Herrmann and Tescher, “A Fundamental Need: Small-Dollar, Short-Term Credit”, p. 5

³ *Ibid.*

⁴ Saunders et al., “Stopping the Payday Loan Trap”, p. 4

⁵ Bair, “Low-Cost Payday Loans”, pp. 6-7

⁶ *Ibid.* at 7

⁷ Logan and Weller, “Who Borrow From Payday Lenders?”, p. 2

⁸ Elliehausen, “An Analysis of Consumers’ Use of Payday Loans”, p. 2

⁹ Caskey, “The Economics of Payday Lending”, p. 2

¹⁰ Logan and Weller, “Who Borrows from Payday Lenders?”, p. 1

income individuals who use these alternative financial products may “lack financial savings, have bad credit and/or high debt-to-income ratios, cite privacy concerns, have a lack of comfort with formal financial services, [and] lack a basic consumer finance education.”¹¹ While borrowers do have checking accounts, they either do not have credit cards, have poor credit scores, or have exceeded their credit limits.¹² Additionally, there is often stigma against borrowing cash from family members or friends, and stigma against returned checks or late fees.¹³ Delaying payment of bills or writing checks that will bounce because of over-limit charges and fees are typically very costly options for borrowers. Thus, there is a specific need for access to these small-dollar short-term cash loans.¹⁴

Payday lending has grown in the past two decades. As of 2007, it was estimated that at least 22,000 payday loan outlets were in existence around the country.¹⁵ Furthermore, estimates suggest that the payday loan industry experienced a six-fold growth between 1999 and 2004, from \$8 billion in loan volume to somewhere between \$40 and \$50 billion.¹⁶ This rapid growth suggests a growing dependency on high-cost lenders by low-income households. In recent years, declines in payday lending have been attributed more to state regulatory action than to decreased consumer demand. Payday lending has persisted as a source of access to quick small-dollar loan amounts, indicating that “the business of lending small-dollar amounts to desperate borrowers at a high cost appears to be at least recession-resistant, if not recession proof.”¹⁷

The Payday Lending Market

In the realm of small-dollar lending, the payday lending market provides access for low-income individuals who might be classified as higher risk consumers, likely due to blemished credit histories. Lenders compensate for this higher risk by charging a higher interest rate, which would allow for the possibility that the borrower does not repay the loan.¹⁸ Studies of business profitability have suggested that payday loans are “efficiently priced as compared to the relatively high operational costs associated with the product.”^{19,20} These high operational costs are exacerbated by the fact that lenders often do not have adequate capital to expand their business and affordably offer loans to consumers.²¹ While opponents of the payday lending industry argue that high interest rates lead to ballooning lender profits, supporters state that the market is competitive and thus that any potential profits are competed away due to the entry of new payday lending outfitters.

¹¹ Birkenmaier and Tyuse, “Affordable Financial Services and Credit for the Poor”, p. 72

¹² Barr, “Banking the Poor”, p. 2

¹³ Lawrence and Eliehausen, “A Comparative Analysis of Payday Loan Customers”, p. 308

¹⁴ Caskey, “The Economics of Payday Lending”, pp. 2-3

¹⁵ Stegman, “Payday Lending”, p. 169

¹⁶ *Ibid.* at 170

¹⁷ Bianchi, “Profiting from Poverty”, p. 11

¹⁸ Caskey, “The Economics of Payday Lending”, p. 15

¹⁹ Bair, “Low-Cost Payday Loans”, p. 29

²⁰ Herrmann and Tescher, “A Fundamental Need: Small-Dollar, Short-Term Credit”, p. 5

²¹ Schneider and Koide, “How Should We Serve the Short-Term Credit Needs of Low-Income Consumers?”, p. 19

Though the payday lending market is competitive, scholars suggest that consumer financial markets are the “textbook case of market failure,”²² largely due to information asymmetries between high-risk consumers and the lenders, which lead to problems of adverse selection and moral hazard. These problems exist because there is no clear and credible way that lenders can discern the high-risk consumers from moderate- or low-risk consumers. Additionally, lenders often do not properly underwrite their loans for capacity to repay, and instead just verify a source of income or checking account.²³ All risky consumers are pooled together and offered similar terms, instead of being separated based on their varying borrower characteristics.

Information asymmetries exist on the consumer side as well, often making borrowers unaware of the terms of their loans. While lenders are required to disclose necessary information pertaining to loans under the Truth in Lending Act (TILA), consumers may not easily understand the financial language.²⁴ For example, some consumers do not have an accurate understanding of just how expensive payday loans are, and report unrealistically low APR rates – or worse – don’t even know their rates.^{25,26} This lack of understanding may lead consumers to inaccurately compare alternative financial products.²⁷ The calculation stipulated by TILA for examining annual percentage rates also excludes loan fees and charges, which may mean that the true cost of the payday loan to consumers is understated.²⁸ Additionally, consumers may lose trust or confidence in the market’s ability to function, which could lead them to abstain from the traditional financial market altogether.²⁹ The inability of lenders to discern between high-risk and low-risk borrowers, the lack of information consumers receive about their loan options, and the lack of incentive consumers have to provide additional information result in a significant market failure.

Use of Payday Loans

The Federal Deposit Insurance Commission’s National Survey of Unbanked and Underbanked Households (2009) revealed that, in total, at least 25% of U.S. households were unbanked (9 million) or underbanked (21 million).³⁰ The U.S. Census Bureau administered this survey to approximately 47,000 individuals regarding their usage of alternative financial services such as payday lenders, rent-to-own stores, refund anticipation loans, and pawnshops. As of 2010, it was the largest survey on the topic of unbanked and underbanked households. “Unbanked” refers to individuals who operate entirely outside the mainstream financial sector, whereas “underbanked” refers to individuals who have a checking or savings account but may also rely on other alternative financial services. Almost 10 million unbanked or underbanked households borrow from these

²² Campbell et al., “Consumer Financial Protection”, p. 3

²³ Bianchi, “Profiting from Poverty”, p. 6

²⁴ Mann and Hawkins, “Just Until Payday”, p. 882

²⁵ Caskey, “The Economics of Payday Lending”, p. 3

²⁶ Lawrence and Elliehausen, “A Comparative Analysis of Payday Loan Customers”, p. 308

²⁷ Mann and Hawkins, “Just Until Payday”, p. 882

²⁸ Plunkett and Hurtado, “Small-Dollar Loans, Big Problems”, p. 50

²⁹ Campbell et al., “Consumer Financial Protection”, p. 3

³⁰ Schneider and Koide, “How Should We Serve the Short-Term Credit Needs of Low-Income Consumers?”, p. 3

alternative financial services for specific small-dollar, short-term needs.³¹ Because payday loans require a checking account or post-dated check, the unbanked population tends to “live at the mercy of fringe banks” that do not require such collateral, such as pawnshops or check cashers.³² Payday lenders generally do not stringently underwrite their loans to assess credit risk or worthiness³³, even though payday loan borrowers typically have a higher risk profile than prime borrowers.³⁴ The underwriting for a loan only consists of assessing whether the individual has a source of income to repay the loan, rather than assessing their capability to do so or past payment behavior. Borrowers generally only have to show a steady source of income or checking account to be approved for a payday loan,³⁵ and payday lenders do not obtain credit reports.³⁶

The Center for American Progress analyzed data from the Federal Reserve’s Survey of Consumer Finances, which collects information about household financial characteristics and habits, and provides data about families’ assets and debt. In 2007, the Survey began collecting information about payday loan usage, which provided the first glimpse of official data collected regarding this industry. While only 2.4% of families reported taking out a payday loan in the past year, overall this population was younger, less educated, had less income, wealth and fewer assets, and was more likely to be a single woman, married couple, or a minority.³⁷

Research indicates that payday loan borrowers are generally between the ages of 24 and 44.³⁸ Not surprisingly, payday loan customers were less likely to be homeowners than nonborrowers³⁹ and thus have a lower usage of mortgage credit.⁴⁰ Forty-two percent of the families that took out payday loans were headed by a single woman and forty percent of the families were married couples. Single men are thus less likely to take out payday loans.⁴¹ Payday loan customers were also more likely to have children,⁴² as 65% of payday loan customers have children younger than 18 living in the household.⁴³ Additionally, payday loan borrowers often had a high school diploma but were less likely to have obtained a college education or degree.⁴⁴ The proportion of families who had been delinquent on a loan in the past year was three times more for those who had taken out payday loans versus those who had not.⁴⁵

³¹ *Ibid.* at 3

³² Washington, “The Impact of Banking and Fringe Banking Regulation”, p.

³³ Lawrence and Elliehausen, “A Comparative Analysis of Payday Loan Customers”, p. 300

³⁴ Center for Financial Services Innovation, “Balancing Convenience and Risk”, p. 1

³⁵ *Ibid.*

³⁶ Elliehausen, “An Analysis of Consumers’ Use of Payday Loans”, p. 2

³⁷ Logan and Weller, “Who Borrows from Payday Lenders?”, p. 1

³⁸ *Ibid.* at 6

³⁹ *Ibid.* at 8

⁴⁰ Lawrence and Elliehausen, “A Comparative Analysis of Payday Loan Customers”, p. 306

⁴¹ Logan and Weller, “Who Borrows from Payday Lenders?”, p. 6

⁴² Caskey, “The Economics of Payday Lending”, p. 2

⁴³ Lawrence and Elliehausen, “A Comparative Analysis of Payday Loan Customers”, p. 306

⁴⁴ Logan and Weller, “Who Borrows from Payday Lenders?”, p. 6

⁴⁵ *Ibid.* at 9

The data showed the median income of payday loan customers was about \$31,000⁴⁶, and industry research has shown that the annual income for borrowers tends to be between \$25,000 and \$50,000, classifying them as lower-middle to middle-income households.⁴⁷ Incomes likely fall within this range because payday loan customers are required to have a checking account to serve as collateral for the transaction; this requirement thus neglects those on the lower end of the socioeconomic ladder.⁴⁸ Payday loan borrowers generally have fairly high income volatility, however, likely due to the nature of their jobs or their education levels; this volatility contributes to their demand for short-term small-dollar loans.⁴⁹

Individuals who had taken out payday loans were less likely to identify themselves as savers than their nonborrowing counterparts.⁵⁰ This is a particularly important issue, as payday loans are generally taken out to cover consumption expenses or for emergencies. Financial behavior issues in public policy are extremely complex, particularly because consumers may not act as “rational utility maximizers” and may instead choose to consume in the present even though saving would permit higher future consumption.⁵¹ Thus, some scholars feel as though payday lending was designed specifically to “exploit both the cognitive limitations and present-biased preferences of certain borrowers.”⁵²

One study found that payday loan customers did not obtain and use bank cards as much as expected, due to a lack of the self-control needed to be able to pay back revolving debt.⁵³ Consumers thus exhibit a lack of control, cognitive capacity or commitment towards saving. Additionally, consumers’ propensity to spend in the present leaves them with little means to be able to repay.⁵⁴ In general, it appears that financial illiteracy is a large problem with the population of individuals that take out payday loans,⁵⁵ and that this illiteracy can lead to “non-trivial financial consequences” when in fact they could be minimized or avoided.⁵⁶

Problems with Payday Loans

Information asymmetries often contribute to financial illiteracy and undermine a consumer’s ability to understand how this market can affect their financial behavior on a greater scale. Research has shown that, while some consumers may be one-time borrowers, more often, once consumers have taken out a loan, they are likely to do so again.⁵⁷ A 2009 report from the Center for

⁴⁶ Saunders et al., “Stopping the Payday Loan Trap”, p. 5

⁴⁷ Caskey, “The Economics of Payday Lending”, p. 2

⁴⁸ Lawrence and Eliehausen, “A Comparative Analysis of Payday Loan Customers”, p. 305

⁴⁹ Blank, “Public Policies to Alter the Use of Alternative Financial Services”, p. 4

⁵⁰ Logan and Weller, “Who Borrows from Payday Lenders?”, p. 10

⁵¹ Campbell et al., “Consumer Financial Protection”, p. 2

⁵² *Ibid.* at 10

⁵³ Lawrence and Eliehausen, “A Comparative Analysis of Payday Loan Customers”, p. 310

⁵⁴ Campbell et al., “Consumer Financial Protection”, p. 2

⁵⁵ *Ibid.* at 4

⁵⁶ *Ibid.*

⁵⁷ Lawrence and Eliehausen, “A Comparative Analysis of Payday Loan Customers”, p. 310

Responsible Lending estimated that, of approximately 19 million payday loan borrowers, 12 million were “trapped in a cycle of at least five payday loan transactions per year.”⁵⁸

Research suggests that many borrowers who take out payday loans are unable to repay within a single pay period and thus have to roll over their loan for another borrowing period, and accrue another fee.⁵⁹ For example, the cost of taking out a payday loan can range from a \$15 - \$22 fee for every \$100 borrowed, which over time can amount to an annual percentage rate ranging from between 390% to 570%.⁶⁰ The Center for Responsible Lending estimated that in 2008, the typical consumer who took out a payday loan ultimately paid \$800 for a \$300 loan, due to the accrual of additional fees and interest.⁶¹ Ultimately, the cost of these additional fees amounts to \$3.4 billion annually, with some estimates suggesting the total consumer cost of payday lending to be \$4.5 billion.⁶²

Lenders claim that when the interest rates and fees are stated in terms of an annual percentage rate, it distorts the purpose of the loan, which is intended to be short-term in nature.⁶³ However for many borrowers, what starts off as a short-term loan turns into long-term payments because of rollover and chronic borrowing patterns.⁶⁴ These rollover options may be helpful in the short-run⁶⁵; however, over time they are particularly risky because they allow these high interest rates to compound and drive already financially vulnerable individuals into further debt.⁶⁶ Additionally, consumers often borrow from multiple lenders and thus accrue varying levels of debt based on their prior loan obligations.⁶⁷ Some estimates suggest that borrowers take out 8-9 payday loans annually.⁶⁸ According to the Center for Responsible Lending, 76% of payday loans are made to consumers who need to pay off previous payday loans they are unable to afford.⁶⁹

Within the industry, only a few states seem to have a standardized database housing information on borrowing and repayment history for payday loan consumers, in order to “enforce restrictions on rollovers and aggregate borrowing.”⁷⁰ While some payday lenders may collect and share data among themselves, the data being collected is not widely available, particularly because these lenders often operate as private entities.⁷¹ Some payday lenders also use databases available from companies like TeleTrack; however, there are indications that this data is often “so spotty that

⁵⁸ Logan and Weller, “Who Borrow From Payday Lenders?”, p. 3

⁵⁹ Herrmann and Tescher, “A Fundamental Need: Small-Dollar, Short-Term Credit”, p. 6

⁶⁰ Bair, “Low-Cost Payday Loans”, p. 3

⁶¹ Logan and Weller, “Who Borrow From Payday Lenders?”, p. 3

⁶² Bianchi, “Profiting from Poverty”, p. 13

⁶³ Caskey, “The Economics of Payday Lending”, p. 3

⁶⁴ *Ibid.* at 32

⁶⁵ Birkenmaier and Tyuse, “Affordable Financial Services and Credit for the Poor”, p. 73

⁶⁶ Saunders et al., “Stopping the Payday Loan Trap”, p. 14

⁶⁷ Stegman, “Payday Lending”, pp. 176-77

⁶⁸ Saunders et al., “Stopping the Payday Loan Trap”, p. 4

⁶⁹ Plunkett and Hurtado, “Small-Dollar Loans, Big Problems”, p. 34

⁷⁰ Elliehausen, “An Analysis of Consumers’ Use of Payday Loans”, p. 7

⁷¹ Flannery and Samolyk, “Payday Lending: Do the Costs Justify the Price?”, p. 4

it is not useful.”⁷² The lack of a centralized system makes it difficult to keep track of where consumers are originating their loans, how often they are taking out payday loans, and their true ability to repay.⁷³ In the mainstream financial sector, consumers are linked to their purchases and spending patterns through their credit score. Short-term loans may not be reported regularly to credit bureaus, since data are generally entered on 30-day cycles.⁷⁴ Reporting data may therefore help these credit deficient consumers build a better credit history and transition to the mainstream financial sector.⁷⁵

Because payday lenders generally do not report borrower behavior to credit bureaus, those consumers that are able to repay are not able to “experience the credit rating benefits associated with timely repayment.”⁷⁶ Consumers are then not really linked to their borrowing history, which might remove the incentive for individuals to fully repay their loans on time. Instead, borrowers may seek loans from other lenders, roll over their debt, seek other means of not repaying their loans, or ultimately declare bankruptcy. In the long term, these strategies are all extremely detrimental to their financial security. Ultimately, this situation does not encourage good safe financial behavior from either the lender or the consumer, and instead creates a “fringe financial class without the capacity to build credit.”⁷⁷

PROPOSED SOLUTION: A RESPONSIBLE LENDING PROGRAM

An analysis of the issues with the payday lending industry reveals a complex problem that justifies reassessing its existence. In a world where no payday loan program exists, low-income, high-risk consumers are unable to obtain loans and have little to no access to short-term cash options. However, in its current design, the payday lending market is rife with information asymmetries, leaving lenders uncertain about risk levels associated with different consumers, and borrowers unaware of the consequences associated with the way the short-term loans are designed. Furthermore, proper incentives do not currently exist in the system to correct these information asymmetries and market failures. Scholars agree that if equivalent programs are designed more “responsibly,” they can be beneficial to the population of consumers that needs the loans and has the capacity to repay.⁷⁸

More responsible loan programs are characterized by a variety of criteria to ensure access to credit without trapping borrowers in additional debt. Characteristics include ensuring that loans comply with state and federal consumer protection and fair lending laws, that loans are underwritten

⁷² Mann and Hawkins, “Just Until Payday”, p. 863

⁷³ Stegman, “Payday Lending”, p. 177

⁷⁴ Herrmann and Tescher, “A Fundamental Need: Small-Dollar, Short-Term Credit”, p. 15

⁷⁵ *Ibid.*

⁷⁶ Fair Community Credit, “Business Plan”, p. 5

⁷⁷ *Ibid.*

⁷⁸ Campbell et al., “Consumer Financial Protection”, p. 11

based upon a borrower's ability to repay, that loan terms are sufficiently long enough to allow for affordable repayment, and that lenders provide additional assistance (e.g. financial counseling or mandatory savings components) to assist consumers.⁷⁹ RAISE Texas, a statewide asset building organization, developed characteristics of affordable loans that allow them to be "reasonably and fairly priced; based on borrower ability to repay the loan and structured so that the borrower can repay without needing to re-borrow; loan term of three months or more is recommended; credit building for borrowers; transparent in advertising, disclosures, and contracts; and includes vehicles to build savings and/or connects borrowers to appropriate financial education."⁸⁰

The National Consumer Law Center (NCLC) states that while desirable, providing savings components or financial counseling is not sufficient.⁸¹ NCLC suggests that any alternative financial product to payday loans should have an annual percentage rate (APR) of 36% or less, should have a term of at least 90 days or one month per \$100 borrowed, should require multiple installment payments rather than one single payment, and should not require that the borrower provide collateral, such as electronic access to their bank accounts or post-dated checks.⁸²

The Federal Deposit Insurance Commission conducted a two-year small-dollar loan pilot program to look at the potential for small-dollar loan systems to profitably replace riskier financial products such as payday loans.⁸³ Twenty-eight banks participated in the pilot program, which collected data on the small-dollar loans (<\$1,000 loans) and nearly small-dollar loans (between \$1,000 and \$2,500 loans) in order to analyze loan characteristics, performance, and repayment rates. Some of the banks already had small-dollar loan systems in place, while others implemented ones specifically for the pilot, according to the FDIC's guidelines. From the program, the FDIC suggests that small-dollar loan programs should include loan amounts of \$2,500 or less, terms of at least 90 days, APRs below 36% (including fees), a streamlined underwriting process to include proof of identity and income, and a credit report (not score) to assess loan amount and repayment capabilities.⁸⁴

Research suggests that consumers should be provided with options regarding pricing, borrowing, and repayment plans, dependent on their specific needs, socioeconomic status, and discipline.⁸⁵ Any program developed as an alternative to a payday lender must keep in mind borrower need and behavior, as well as what would happen if access to these loans were eliminated.⁸⁶ Additionally, because of the varying characteristics of borrowers, "market segmentation" is a critical consideration in any alternative loan program.⁸⁷

⁷⁹ New Yorkers for Responsible Lending, "Principles of Sound Small-Dollar Lending", p. 2

⁸⁰ Baddour et al., "Reshaping the Future of Small-Dollar Lending in Texas", p. 29

⁸¹ Saunders et al., "Stopping the Payday Loan Trap", p. 1

⁸² *Ibid.*

⁸³ Federal Deposit Insurance Commission, "A Template for Success", p. 28

⁸⁴ Kovach, "The Changing Landscape for Alternative Small-Dollar Loans", p. 1

⁸⁵ Herrmann and Tescher, "A Fundamental Need: Small-Dollar, Short-Term Credit", p. 13-14

⁸⁶ Campbell et al., "Consumer Financial Protection", p. 11

⁸⁷ Schneider and Koide, "How Should We Serve the Short-Term Credit Needs of Low-Income Consumers?", p. 6

The Center for Financial Services Innovation (CFSI) suggests that a payday loan alternative will be successful with a competitive pricing structure that may allow for longer loan terms, a fast turn-around to compete with the immediacy associated with payday loans, an emphasis on building relationships with borrowers, and a mechanism by which to minimize potential losses on loans.⁸⁸ (See Appendix A for CFSI's suggestion on risk management strategies associated with payday lending.) Furthermore, successful loan programs most often have strong board support, a visionary leader for the program, and proximity to the consumer population in need of the loans.⁸⁹ However, "while regulation should be designed to protect consumers, it must also be cognizant of business realities."⁹⁰ The tension then in designing an alternative program is in balancing consumer need and incentive, market failures in information asymmetries, and business profitability concerns in order to meet the demand for these loans while not encouraging or incentivizing unscrupulous or predatory behavior.

⁸⁸ Center for Financial Services Innovation, "Balancing Convenience and Risk", p. 1

⁸⁹ Illinois Asset Building Group, "Alternative Small-Dollar Loans in Illinois", p. 4

⁹⁰ Campbell et al., "Consumer Financial Protection", p. 11-12

CRITERIA

The following criteria are used to analyze each alternative proposed below.

- **Minimize risk associated with consumers' ability to repay loans:** Risk associated with consumer behavior and/or ability to repay is a significant concern in the small-dollar lending industry. This criterion aims to reduce that risk by either better assessing consumer riskiness or ensuring that whatever consumer risk does exist does not prohibit or limit the potential for the loan to be repaid. Any alternative must minimize this risk in order to ensure that lenders continue to provide the option for access to short-term small-dollar loans.
- **Provide incentive for lenders to make loans with a positive expected value:** In order to operate as a business, lenders must be able to make a profit or a positive expected return from the loans they extend. Because the demographic that tends to need small-dollar lending may be risky, incentive must be offered for lenders to rationally extend a loan without using discriminatory criteria. A viable alternative will provide this incentive by reducing consumer risk, allowing lenders to better examine consumer risk, or by guaranteeing that they will be compensated for the risk associated with the population they are serving.
- **Provide incentive for consumers to improve behavior:** Consumers are not necessarily linked to their borrowing and repayment histories and thus are provided with little incentive to improve their borrowing behavior. A viable alternative should provide a mechanism by which consumers choose to improve their own repayment behavior, in order to ensure lenders receive the return on the loans that they make and continue to provide access to the small-dollar loans.
- **Maximize sustainability of program implementation:** Any recommended program design should consider factors of sustainability, such as cost considerations, simplicity of implementation, political pushback, or scalability concerns. Any alternative examined should attempt to maximize the sustainability of the program design in order to ensure the program's continued existence.

ALTERNATIVES

The following alternatives provide plausible program designs for a responsible small-dollar lending program. Each alternative will be discussed in detail and weighted against the specific criteria identified above. Each criterion is weighted equally in the analysis.

1. Use a referral process to provide loans to approved low-income and/or high-risk consumers.
2. Design a borrower's card system to collect information about consumers' borrowing and repayment behaviors.
3. Fund a loan loss reserve pool to back loans made to low-income and/or high-risk consumers.

ANALYSIS

The following analyses are based on the distinct design components, and not the specific city or state programs on which they are based. This analysis also seeks to analyze the design components independent of one another in implementation. Finally, it should be noted that all of the alternatives continue to provide the option for access to short-term small-dollar lending.

Alternative 1: Referral Process to Provide Loans

This alternative is designed after the Fair Community Credit program in Kansas City. This program uses a \$200,000 loan loss reserve and a referral process from Fair Community Credit trained referral partners to make loans to low-income individuals or subprime borrowers. The loan loss reserve is funded by foundations and individuals, as well as the interest generated in the account in which it is held at the partnering bank (in the case of Fair Community Credit, Central Bank). The program caps interest rates at 36%, limits borrowers to one loan at a time, and offers optional financial education to clients. Loan amounts will range from \$300 to \$2,500 for terms between 4 months and 24 months, and in the first year of operation, the program expects to make 500 collateralized loans.⁹¹

Research has suggested that lenders need to understand how to incorporate and leverage borrowers' social networks into the lending process.⁹² The referral process used by Fair Community

⁹¹ Associated Press, "Kansas City Group Creates Alternative to Payday Loans", p. 1

⁹² Schneider and Koide, "How Should We Serve the Short-Term Credit Needs of Low-Income Consumers?", p. 78

Credit is based on community, peer-based international microfinance programs⁹³ that suggest that loans made to individuals within a community or existing social network are more likely to be repaid because individuals have been identified as responsible or trustworthy.⁹⁴ The group cites the Grameen Bank’s 97% rate of repayment and attributes this success to the monitoring within social networks that exerts social pressure to repay, as well as provides windfall in the case that borrowers experience financial distress.⁹⁵ Fair Community Credit uses a referral system of trained community and neighborhood institutions that seek to replicate the Grameen Bank’s “village” concept and that share Fair Community Credit’s mission. These institutions may be nonprofit organizations, congregations, or social service providers that have been specifically identified and targeted to join the referral network. Training is provided by professional community organizers.

A “good referral” meets four characteristics: borrowers have an acute and specific financial need; borrowers have a pre-existing relationship with a referral partner; borrowers have a willingness to improve their financial situation; and borrowers meet the minimum criteria for underwriting.⁹⁶ After receiving a letter of endorsement in the referral process, information about the client’s loan is entered into an online tracking system to which only the referral partner, the partner bank representative, and Fair Community Credit have access. The online tracking system is not used to collect sensitive information, such as social security numbers or credit scores. Fair Community Credit uses this system to track referrals made by each partner in the referral network to ensure that quality referrals are being made by each referral partner. After receiving a referral, all borrowers must also undergo an underwriting process with the partnering bank before qualifying to receive the loan.

Analysis of Alternative 1

The following decision matrix displays how each alternative measures against the specified criteria. A scale of -2 to 2 is used in this decision matrix, with -2 indicating that the alternative does not meet the criterion, -1 indicating that the alternative probably does not meet the criterion, 0 indicating an unclear outcome, 1 indicating that the alternative probably meets the criterion, and 2 indicating that the alternative fully meets the criterion.

Repayment Risk	Lender Incentive	Consumer Incentive	Sustainability
1	0	0	1
<i>-2 = does not meet criterion; -1 = probably does not meet; 0 = uncertain; 1 = probably meets; 2 = fully meets</i>			

⁹³ Herrmann and Tescher, “A Fundamental Need: Small-Dollar, Short-Term Credit”, p. 12

⁹⁴ Fair Community Credit, “Business Plan”, p. 11

⁹⁵ Fair Community Credit, “Business Plan”, p. 11

⁹⁶ Martinez (Fair Community Credit), Phone Call of March 14, 2012

Minimize risk associated with consumers' ability to repay loans

The risk associated with repayment stems from uncertainty about the individual's ability to repay the loan, particularly based on past behavior. Using a referral system ensures that individuals are vouched for as being responsible, trustworthy, or reliable. Furthermore, a referral system provides some mitigation of risk, particularly compared to a walk-in customer for whom there is no basis for assessing their ability to repay. The referral system makes use of trusted community partners that are able to speak to a consumer's character, morals, or other related characteristics that might affect their tendency to repay beyond just their financial means.

A limiting factor here is that the referral process can be considered completely subjective. This alternative thus partially meets the criterion of minimizing risk associated with a consumer's ability to repay. If a referral partner could be properly trained to assess a "good referral" and a standardized procedure is agreed upon, this could help minimize the subjectivity associated with the process. Additionally, a referral process that uses referrals from a variety of different sources may be more reliable, as it would increase the support for a particular consumer and not depend on one source. Finally, a referral process accompanied by a way to collect and track information on borrowing history (as in the Fair Community Credit Program) would help distinguish between "good" and "bad" referees. This might strengthen the validity of the referral as a vouching mechanism.

Provide incentive for lenders to make loans with a positive expected value

If a standardized, proper referral system is used, borrowers may be perceived as lower risk to lenders. However, it is uncertain whether utilizing a referral system is enough incentive for lenders to extend loans to borrowers that they expect to yield a positive expected value. The subjectivity concerns with a referral may undermine the process in general. Referral and community partners may be biased to speak highly of the borrowers, since it is in their interest to recommend their clients to the bank, so as to better serve their population of interest. Banks and lenders are more concerned with repayment, and without a guarantee of collateral or profitability, the referral may not be enough to incentivize them to extend loans.

Provide incentive for consumers to improve behavior

It is uncertain whether a referral system would really provide a concrete incentive for consumers to improve repayment behavior, particularly if the referral is based on a pre-established relationship (e.g. a parishioner and a congregation). Indirectly, borrowers may try to utilize their relationships with community partners more in order to gain favor. However, because the referral is more of an assessment of the consumer's situation and need, it may not directly provide the incentive to improve behavior.

Maximize sustainability of program implementation

By using a referral system, the pool of borrowers is kept relatively small, since community partners would have to base their referrals on established relationships, extensive counseling, and referral meetings. Keeping this pool of borrowers small helps with sustainability because funds would not be at as high of a risk of default as they might be with a larger pool of uncertain, risky borrowers. One advantage of using a referral process is that community referral partners can always be added to the program if others decide to stop participating, or if the program needs to be expanded. With no dearth of social service providers, advocacy groups, and congregations in most low-income areas, there is a replenishing supply of potential partners.

If default rates are really as low as implied by the Grameen Bank's 97% of repayment, this fact will help with sustainability, since over time lenders may observe that the consumers being referred are reliable. A relationship might thus develop between lenders and these referral partners, which could help increase program sustainability. However, more evaluation is needed to determine default history and repayment with the referral process.

Alternative 2: Borrower's Card to Collect Information

This alternative seeks to design a program similar to the discount cards that common grocery stores offer, by which these cards are free to obtain and are used to track a consumer's purchases and spending histories while offering small discounts on products. In the case of a grocery store, the card provides consumers with discounts and the store with information about consumer spending, which in the long run is likely more valuable than the amount of the discounts offered.

Individuals who desire a small-dollar loan could opt into this voluntary card program, run by an existing credit union. Each individual would receive a personalized borrower's card and would be required to submit a fingerprint scan to receive one, to minimize the chance of obtaining numerous cards. This card would not be linked to an individual's social security number, so as not to alienate those that may not have traditional jobs or documentation, but would be a voluntary information collection system. Each time a consumer receives a small-dollar loan, information about the loan amount, the borrowing date, the interest rates, and their repayment schedule could be collected electronically, in order to capture where and how often consumers are receiving a loan, as well as their repayment behavior. The loan would not necessarily have to be received through this borrower's card, though there are program models (such as Progreso Financiero) that provide their loans through a pre-paid card.⁹⁷

An incentive system can be worked into the program design, whereby consumers could receive a rating, similar to a credit score yet not linked to the traditional credit score system or social security number. This "shadow credit rating" would collect information from these borrower's cards

⁹⁷ Baddour et al., "Reshaping the Future of Small-Dollar Lending in Texas", p. 48

and would adjust based on how quickly a consumer repaid their loan, whether a consumer received financial counseling, whether a consumer participated on financial education or homeownership classes, whether a consumer opened a savings account or maintained a minimum balance, or a variety of other factors. These behaviors would provide bonus points for the “shadow credit score.” Progreso Financiero has developed its own credit assessment underwriting model that uses an in-depth online questionnaire as well as over 1,300 attributes of nontraditional data such as rental history, utility payments, and home or car ownership.⁹⁸ It has done so primarily because only 3% of its loan applicants have a sufficient credit history or high enough credit score.⁹⁹

To incentivize consumers to build higher “shadow credit scores,” incentives such as lowered interest rates, longer repayment plans for those who have established reliable payment histories, or higher loan amounts could be offered. Under the Progreso Financiero model, individuals who repay their loans on time are able to receive better terms on their next loan.¹⁰⁰ Progreso Financiero also reports borrowers’ payments to credit bureaus and found that almost 90% of their borrowers increased their credit score from their first loan.¹⁰¹

Some discussion of innovative small-dollar lending programs has centered on whether consumers can transition to the mainstream financial system after a certain amount of time.¹⁰² With the borrower’s card, if consumers reach a “shadow credit score” of a certain threshold amount based on their behavior and loan repayment, they may reach interest rate levels with the small-dollar lending institution comparable to the prime interest rates they could obtain at a bank. Then, slowly and with counseling, consumers may be able to transition over to the "traditional" banking sector.

Piloting this program at an existing community financial institution or credit union may help to link up the “shadow credit ratings” with real credit scores. Further, an existing credit union may experience lower operating costs due to preexisting infrastructure, staff, physical space, and processes.¹⁰³

Analysis of Alternative 2

Repayment Risk	Lender Incentive	Consumer Incentive	Sustainability
2	1	1	1
<i>-2 = does not meet criterion; -1 = probably does not meet; 0 = uncertain; 1 = probably meets; 2 = fully meets</i>			

⁹⁸ Del Bosque, “Taking An Interest: A New Business Model Challenges Predatory Payday Lenders”, p. 1

⁹⁹ Baddour et al., “Reshaping the Future of Small-Dollar Lending in Texas”, p. 47

¹⁰⁰ Moran, “Some Ways To Get Started as a Social Entrepreneur”, p. 2

¹⁰¹ Saunders et al., “Stopping the Payday Loan Trap”, p. 23

¹⁰² McKernan and Compton, “Developing A Research Agenda”, p. 6

¹⁰³ Bair, “Low-Cost Payday Loans”, p. 28

Minimize risk associated with consumers' ability to repay loans

The premise behind this borrower's card is focused on increasing data collection on a consumer's loan history, borrowing behavior, and repayment ability, and making it available among lenders participating in the borrower's card program (e.g. participating credit unions). This system fully meets the criterion of minimizing risk associated with a consumer's ability to repay loans.

First, the card would hold consumers responsible for their lending and borrowing patterns by linking their behavior to their potential to obtain a loan. Additionally, the borrower's card acts as a separating mechanism, which distinguishes individuals who are in genuine need of a loan and able to repay from those who may need the loan but cannot repay and instead take out additional loans or roll over their interest fees. The card provides an incentive for consumers who frequently borrow and repay their loans to engage in the program because of the potential to receive reduced interest rates, larger loan amounts, and varied payment plans. The data collection thus helps to separate very risky individuals (who likely would not qualify for a loan at all) from those that are less risky. This provides an incentive for high-risk consumers to improve their behavior. However, to the extent that this tranche of consumers does not improve behavior, it is important to acknowledge the possibility of their financial outcomes becoming worse because the moderate- or low-risk individuals who were once pooled together with them will no longer be subsidizing their loans.

Amassing any large database of information may potentially pose privacy concerns, especially if a biometric mechanism were used to ensure that borrowers could only receive one card. However, there are ways to minimize privacy concerns. The data collected could exclude personally identifiable information, such as social security numbers and credit scores. The database should be nonpublic and only shared with participating lending institutions and credit unions that agree to the loan terms of the program. This provision would exclude any payday lending operation from having access to the database since their loan terms and interest rates would not comply with program design. Further, limiting access to the information may encourage more credit unions to participate in the program so they are able to receive information about their potential borrowers.

Provide incentive for lenders to make loans with a positive expected value

In order for lenders to extend loans to an individual, there must be some assurance of breaking even on the loan or making a profit. When repayment is an uncertainty, lenders are less likely to extend a loan to an individual. The borrower's card system would create a database of information on a consumer's borrowing and repayment history that the lender would be able to view. This database would provide lenders with incentive to extend loans for two reasons. First, lenders are able to view the select financial behavior of consumers to assess their ability and history of repayment. Secondly, consumers who are more likely to frequently borrow and repay are more likely to use this card because of the potential for a reduced interest rate. Thus lenders have some indication that the borrower is able and willing to repay, in order to receive the reduced rates. This mechanism is somewhat comparable to the way in which the credit card industry has used market

segmentation to offer varying terms and interest rates to consumers based on their respective financial characteristics. According to some, “[t]here is every reason to think that the same advances that information technology has brought to the credit card industry in this country could be useful in the payday lending industry as well.”¹⁰⁴

It is important to acknowledge the trade-off that very high-risk consumers who frequently take out loans they are unable to afford may be shut out of the borrowing market using this mechanism, because it exposes their behavior and inability to repay. However, it is not the goal of a responsible lending program to ensure that every individual who needs a loan receives one. The National Consumer Law Center states “the criteria for responsible small loans must be considered on their own merits, without excessive concern for whether or not they will permit the wide availability of easy credit that gets payday borrowers in trouble today.”¹⁰⁵ It is thus critical that those who need loans and are able to repay are not denied access because they are clustered in a group of borrowers that are all considered to be high-risk. The separating mechanism from the borrower’s card will help to discern between these risk classifications and will not provide loans to those who need them but have no capacity to repay them.

Provide incentive for consumers to improve behavior

This alternative creates an incentive for consumers to participate in this program, particularly for consumers that frequently take out these loans or genuinely need these loans to supplement their income. By taking ownership of their borrowing behavior and building a history of good repayment, consumers are able to receive needed financial assistance at a potentially lower interest rate. Additionally, individuals can demonstrate through their behavior their ability to repay and thus, their lower risk as a borrower. This feature helps to address issues of adverse selection in the population.

A few states have created centralized databases for information regarding consumers’ payday loans, in order to prevent rollover or chronic borrowing.¹⁰⁶ However, these databases simply collect information for lenders to use and do not seem to provide consumers with any incentive to improve their own financial behavior. This can be contrasted to the borrower’s card design, which would use the possibility of reduced interest rates to incentivize higher repayment rates and better loan terms; so the better their shadow credit score, the lower their interest rate. However, this makes the assumption that interest rates are a strong enough incentive mechanism. Other incentives might be longer repayment plans for those who have established reliable payment histories or higher loan limits. Furthermore, the potential for using good repayment behavior in the construction of a “shadow credit score” as the basis for transitioning to the traditional banking sector would provide individuals who are typically unable to access prime interest rates with incentive to work towards that goal.

¹⁰⁴ Mann and Hawkins, “Just Until Payday”, p. 912

¹⁰⁵ Saunders et al., “Stopping the Payday Loan Trap”, p. 8

¹⁰⁶ Elliehausen, “An Analysis of Consumers’ Use of Payday Loans”, p. 7

Maximize sustainability of program implementation

This alternative helps to create a long-term relationship between consumers and their borrowing behavior, by pegging an individual's history and propensity to repay to the interest rates and loan terms they receive. Individuals are thus linked to their borrowing behavior over time, creating a more sustainable lending model than ones that simply allow individuals to take out many loans from a variety of lenders. In the case of a state where it might be difficult to block political legislation that allows payday lending to take shape, this alternative might provide a way of tackling the issue from the other end, by reducing the need and demand for those payday loan shops and encouraging more of a reliance on credit unions or other community lenders.

This alternative would likely meet this criterion, but because it would need to be piloted at an existing credit union or financial institution, information about pilot program scalability would need to be assessed. Furthermore, evaluation of existing state databases would provide useful guidance in program design. Using the shopper's discount card as a model, however, because costs of implementation are likely fairly low and highly replicable, the potential for expanding this program to other credit unions to maximize sustainability is high.

Alternative 3: Loan Loss Reserve Pool to Back Loans

In the small-dollar lending industry, borrowers tend to be risky and lenders are often hesitant to provide loans without some sort of collateral or guarantee of repayment. This alternative would create a loan loss reserve pool of funds in order to back the loans made to these borrowers. This fund would be used in the case that borrowers are unable to repay the loan to the lending institution, in order to ensure that the lender is able to break even and not lose profits for extending the loan. The loan loss reserve fund would help lenders obtain more financial capital to help expand their business and increase the number of loans that can be made affordably.¹⁰⁷

Depending on the design, loan loss reserve pools can back the loans in entirety, or can partially back the loans up to a certain percentage, leaving the lender to potentially face some risk of loss. Loan loss reserve pools can also be funded in different ways. The Fair Community Credit program's loan loss reserve pool is funded by individual and community donations, and is held in a Certificate of Deposit at the bank with which they partner. The fund earns interest and is used to 100% back the loans made to individuals who have been referred to the partner bank by trained referral partners. In contrast, the Pennsylvania Credit Union Better Choice program funded their loan loss reserve pool from the monies earned above the market rate-of-return on a \$20 million dollar investment from the Pennsylvania Department of Treasury into the credit union system.¹⁰⁸ The loan loss reserve pool was then used to reimburse up to 50% of any lender losses.¹⁰⁹

¹⁰⁷ Schneider and Koide, "How Should We Serve the Short-Term Credit Needs of Low-Income Consumers?", p. 19

¹⁰⁸ Federal Deposit Insurance Corporation, "A Template for Success", p. 35

¹⁰⁹ Schneider and Koide, "How Should We Serve the Short-Term Credit Needs of Low-Income Consumers?", p. 11

Analysis of Alternative 3

Repayment Risk	Lender Incentive	Consumer Incentive	Sustainability
2	1	-2	-1
<i>-2 = does not meet criterion; -1 = probably does not meet; 0 = uncertain; 1 = probably meets; 2 = fully meets</i>			

Minimize risk associated with consumers' ability to repay loans

Lenders are concerned with ensuring that whatever loan they extend will be repaid to them, typically so their business can break even or make a profit. In general, lenders are more concerned about protecting their business from loss. The loan loss reserve pool serves as a guarantee against potential losses and thus ameliorates the risk of consumers not repaying their loan. Depending on the design of the loan loss reserve and to what percentage the fund can guarantee the loan, it either partially or fully meets this criterion. However, it is important to note that the loan loss reserve pool circumvents any aspect of consumer behavior, intention, or ability to repay the loan and instead is set up with the lender's interests and profitability concerns in mind.

Provide incentive for lenders to make loans with a positive expected value

The loan loss reserve alternative partially meets the criterion of providing lenders to make loans with a positive expected value. The concern with a loan loss reserve is with whether lenders are provided with too much incentive to make loans to any individual simply to ensure a profit. With the assumption that all loans are backed, similar to the manner in which mortgage loans were assumed to be backed by Fannie Mae and Freddie Mac during the recent housing crisis, potentially risky consumers may be offered loans when in fact they cannot afford them. A blanket guarantee against any loan losses makes riskier loans seem more attractive than they should be, because lenders know they will be able to break even in any case. With the loan loss reserve pool, it is thus critical to ensure lenders are provided with the right incentive to make loans on which they can still expect to receive a positive return. A partial reimbursement may provide the correct amount of incentive while not overcompensating the risk pool.

Provide incentive for consumers to improve behavior

This alternative does not meet the criterion of providing consumers with incentive to improve their own repayment behavior. The loan loss reserve pool is used to back all loans made to consumers with the hope that lenders will find more incentive to extend loans. Consumers are thus aware that even if they are unable to repay, the lender will still receive a return on the loan. With a loan loss reserve pool, consumers are not necessarily held accountable for the loans they receive. Further, the loan loss reserve actually de-links consumers from their borrowing history by implying

that as long a loan is repaid, no matter by whom, the loan is appropriate to make. This situation reduces the obligation borrowers feel to repay.

Even if penalties are imposed on consumers in order to induce them to repay, the loan loss pool itself is not incentivizing the improvement in their behavior. This can be a particular problem for more high-risk consumers, who may seek out these small-dollar loans more frequently than otherwise since they know that the loans are backed and that lenders may be more willing to extend to them a loan.

Maximize sustainability of program implementation

The critical concern with sustaining a loan loss reserve pool is where the funds will come from and how the pool can stay replenished throughout time. Within the program design, there may be ways to include additional fees to help sustain the loan loss reserve. For example, for every consumer that takes out loan, they could pay a one-time initiation fee or an annual fee that could fund the pool. However, this tactic poses additional trade-offs with access, because consumers who need a small-dollar loan very infrequently will be essentially penalized and required to pay more, on balance. Further, annual fees may actually encourage those consumers to take out more loans, particularly if they are being subject to a lump sum fee for usage. Finally, the concept of charging additional fees may not be consistent with the idea of offering an alternative to payday lending, which hinges its own profitability model on additional fees to consumers. Thus, while there are ways to incorporate additional mechanisms by which to obtain funds for a loan loss reserve, they come with significant trade-offs.

The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 included a provision for grants to fund federally backed loan loss reserves for community development financial institutions.¹¹⁰ According to the legislation, the purpose of establishing these grants was to provide financial assistance for CDFIs that engage in small-dollar lending to “defray the costs of operating small-dollar loan programs, by providing the amounts necessary for such institutions to establish their own loan loss reserve funds to mitigate some of the losses on such small-dollar loan programs.”¹¹¹

The involvement of the federal government in supporting loan loss reserves may ensure more sustainability; however, given a tough economy and the political controversy over this legislation, it is uncertain whether this provision will actually improve the potential longevity of implementation.

¹¹⁰ H.R. 4173, “Dodd-Frank Wall Street Reform and Consumer Protection Act”, Section 1206

¹¹¹ *Ibid.*

RECOMMENDATION

Based on the problems identified with the small-dollar lending industry, as well as the results and designs of pilot programs and policies in other parts of the country, Alternative 2 would provide the most opportunities for flexibility with program design to create an alternative responsible small-dollar lending program. This alternative would also increase data collection on the borrowing patterns of consumers that tend to require small-dollar loans, which may provide insight into how to further design programs to appropriately target individuals based on their level of risk. Finally, while Alternative 1 and Alternative 3 offer benefits to a program design that the borrower's card perhaps cannot, Alternative 2 best tackles the issue of incentivizing responsible small-dollar lending by both encouraging lenders to extend loans to low-income individuals in need and encouraging consumers to develop a long term relationship with their borrowing pattern and take ownership of their own financial behavior.

	Repayment Risk	Lender Incentive	Consumer Incentive	Sustainability	TOTAL
Referral Program	1	0	0	1	2
Borrower's Card	2	1	1	1	5
Loan Loss Reserve	2	1	-2	-1	0
<i>-2 = does not meet criterion; -1 = probably does not meet; 0 = uncertain; 1 = probably meets; 2 = fully meets</i>					

APPENDIX A: CFSI RISK MANAGEMENT STRATEGIES¹¹²

BALANCING RISK, PROFITABILITY, AND CUSTOMER CONVENIENCE IN PAYDAY LENDING

Risk Management Strategy	Impact on Risk Profile	Impact on Customer Convenience and Loan Volume
Restrict number of loans a customer can take out per year	- Lowers exposure to bad loans, but may drive borrowers to higher-cost lenders	- Less convenient - Using higher-cost lenders increases default risk
Institute more stringent repayment guidelines; i.e., loans must be paid off in full before taking out another	- Lowers overall exposure - Cuts delinquencies - May drive borrowers to high-cost lenders	- Less convenient for borrowers - Cuts loan volume
Require credit counseling	- May lower risk profile by weeding out people who just want the money	- Less convenient for borrowers - Cuts loan volume
Require payment through direct deposit	- Improves profit and lowers risk by giving lender first shot at paycheck, though not all regulators may allow this	- Limits loans to people with regular jobs - May sideline workers with informal-sector income - Only accessible for workers with payroll departments willing to set up direct deposit
Increase fees (with or without requiring membership or banking relationship)	- Can make payday loans profitable as products - Little impact on default risk	- Less convenient - Cuts loan volume, usually by making a loan program available only to credit union members
Institute "emergency only" provisions	- Lowers risk profile by discouraging chronic borrowing - Cut checks directly to vendors to ensure money goes to emergency purpose	- Very inconvenient: By definition emergency borrowers need cash immediately, and can't wait 2-3 days for emergency loan approval
Restrict loans based on credit scores	- Lowers risk profile	- Cuts loan volume
Build relationships with employer groups	- Lowers risk by offering point of intervention if loan is in arrears	- May cut loan volume, but also may help improve credit score if employers can assist with repayment through direct deposit or pressure

¹¹² Center for Financial Services Innovation, "Balancing Convenience and Risk", p. 6

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