Small-Dollar Credit

Consumer Needs and Industry Challenges

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For low- and moderate-income Americans, managing finances can be a tightrope walk. Expenses and income must be balanced carefully. Sometimes, bills come due before the paycheck arrives. At other times, life's emergencies—a broken-down car, an unplanned trip to the emergency room—can throw things off balance. Hardship can ensue as many of these families have no emergency fund. Others may have a nest egg they are hesitant to dip into.

To deal with these challenges, many households turn to the small-dollar credit market: short-term loans, usually for a few hundred dollars, with relatively short repayment periods. The market for very short-term credit reached an estimated $21.4 billion in 2012 (Wolkowitz and Oh 2013). While the market is often associated with alternative financial service providers such as payday lenders and pawn shops, a small number of banks experimented with deposit advance products that enable customers to take small loans repayable with a fee from their next eligible deposit, usually a paycheck. Banks are exploring ways to provide valuable credit products to low- and moderate-income consumers.

In January 2014, the Urban Institute convened 25 small-dollar credit researchers, credit union experts, and bank representatives to discuss the opportunities and challenges of providing small-dollar credit products. Reviewing current research and findings from existing experiments in providing small-dollar credit, these 25 experts identified product features that could appeal to consumers and provide access to safe, affordable credit as well as obstacles to bringing such features to scale. This brief summarizes the convening discussion.

Consumer Needs and Product Features

Households tend to turn to small-dollar credit products for four reasons: to pay for unexpected expenses (32 percent), to cover temporary income shortfalls (32 percent), to make large planned purchases (9 percent), or because they face chronic income shortfalls (30 percent; see Bianchi and Levy 2013). Participants identified credit as inappropriate for this final group. These different needs underscore the diverse circumstances faced by low- and moderate-income households, who often face uneven income streams and must make tough financial decisions among many competing financial needs (Morduch and Schneider 2013).

Ability to repay, flexibility, transparency, and user-friendly features, such as clear disclosures and the capability to make mobile payments and receive reminders about payment due dates, were among the product features identified by researchers as important for consumer success. Table 1 summarizes product features for small-dollar credit mentioned by participants. Discussion of affordability and ability to repay centered on repayment structures favoring installments over the short-term, lump-sum payments typical of existing products and ensuring that the size of each repayment is manageable based on consumer circumstances.

TABLE 1

Consumers Needs and Product Features

Product features	Examples
Ability to repay	Repayment amounts no more than 5 percent of the consumer's paycheck (Bourke et al. 2013). Fees spread over course of the loan, not "front-loaded."
Flexibility around repayment	Allow for small and variable loan repayment amounts.
Transparency and simplicity	Transparent, easy-to-understand disclosure of terms and conditions. Easy application and repayment design.
Bundle products	A credit product bundled with a savings product, either by saving a portion of the original loan or encouraging consumers to make payments into a savings account after loan is repaid.
Structure product for "small successes"	Automatic alerts when a deposit is made to the consumer's account that encourage (but do not require) the user to pay down his/her loan or save a portion of the deposit.
Convenient, fast underwriting	Use ongoing relationship with the customer to quickly assess borrowing capacity.
Mindful of consumer's context	Fast, courteous customer service. Consumers are directed to the credit and savings products most appropriate for their needs.

Participants noted that consumers are often uncomfortable with debt and thus find short-term, lump-sum loans appealing. However, consumers often cannot repay these loans without renewals and more fees. Might consumers choose the two-week storefront payday loan over the bank loan with a six-month repayment period? One suggested product would allow consumers to choose a short initial repayment window (e.g., two weeks or one month); if the loan is not repaid within that window, then it automatically transfers to a longer-term installment loan. Such a product would provide consumers with a choice and a sense of control at the outset, while also providing guardrails to promote success.

Participants agreed that product designs should incorporate behavioral insights to guide consumers toward decisions that will enable success. The group was cautioned, however, not to "overdo it" with default features (e.g., opt-out), as choice (i.e., control) can nudge people into the right decision.

Drawing from recent and ongoing pilots, participants discussed the potential for small-dollar credit products to move beyond simply providing short-term credit to consumers. Innovatively designed products that bundle credit with savings could provide pathways to greater financial stability by enabling consumers to build savings while paying down debt. For example, credit unions participating in the Borrow & Save program provide consumers with small-dollar loan products that require them to save a portion of the loan (National Federation of Community Development Credit Unions 2013). The Pay Yourself Back pilot developed by Innovations for Poverty Action capitalizes on the habit of repaying an installment loan by encouraging borrowers to continue making routine payments into a savings account after their loan is repaid. While not a credit product, the Rainy Day Reserve savings feature on prepaid cards enabled consumers to build up a small safety net for emergencies, which subsequently reduced consumers' use of credit from payday loans and pawn shops (Abbi, Hasan, and Straghalis 2013). These products underscore the potential for financial institutions to use small-dollar credit products to build relationships with consumers and then graduate consumers to products that build assets (Center for Financial Services Innovation 2014).

Another innovative product feature originally piloted for subprime auto loans (Lower Interest for Timeliness) rewarded participants who made installment payments on time with lower interest rates. This feature modestly lowered loan delinquency among borrowers and improved customers' perception of their credit union (Collins, Sydnor, and Gjertson 2014).

Given the diversity of consumer situations, a single product is unlikely to adequately meet all consumer needs. A key challenge is for providers to develop flexible products responsive to these needs.

Industry Challenges

For providers wishing to offer small-dollar credit products, roundtable participants identified two major challenges: achieving profitability and navigating a complex and changing regulatory environment. Table 2 summarizes the major points participants offered regarding these challenges.

TABLE 2

Provider Challenges and Perspectives

Provider challenges	Examples
How to underwrite loans	More data are needed to define ability to repay; credit scores can bring regulator/examiner problems; create a level regulatory playing field between banks and other small-dollar credit providers (e.g., payday lenders).
Flexibility around repayment raises safety and soundness concerns	Small amounts, variable repayment, and long repayment terms can increase loss rates and raise safety and soundness concerns.
Profitability is a key concern for banks	Small loans mean small margins. Small-dollar credit product development is competing with other product lines for resources.
Cooling off periods are not acceptable to the consumer	Cooling off periods generate consumer complaints and damage bank-consumer relationships.
Segmenting consumers can raise regulatory or examiner concerns	Offering two consumers different prices and products can raise segmentation concerns. Segmenting is an obstacle to developing multiple products and directing consumers to products that are appropriate for them, or providing consumers with choices.
Installment loans can be expensive to administer	Installment loans require an infrastructure for tracking repayment, providing statements, and providing other administration. For small loan amounts, this infrastructure may not always be cost-effective.
Banks have little room to innovate without regulatory risk	A safe harbor for product design could allow experimentation, testing, and empirical evidence on questions about whether lump-sum or installment repayment schedules work better for consumers using small-dollar credit.
New products associated with small-dollar loans can bring examiner and advocate scrutiny	The terms "small-dollar credit" and "payday loans" have acquired a negative perception that can raise questions and damage a bank's reputation.

For example, participants pointed out that profitability is a key concern for banks, though consumer relationships are also important. Internally, small-dollar credit products are competing with other product lines (e.g., home or car loans) for resources. Thus, beyond the profitability of the product is the opportunity cost of developing and offering the small-dollar credit product over another product. Participants noted that banks seek the highest return for a given level of risk on the products and services they offer. Key questions include what does the product cost, and how quickly does the consumer repay? How much bank capital will be tied up and for how long? Small loans can mean small margins because the overhead costs required for underwriting and managing the loan can be large relative to the loan size. Even "mission-driven" credit unions and nonprofit organizations must offer products with financially sound business models. "Without margin there is no mission," as one participant noted.

Another challenge raised was how to underwrite loans. For example, participants noted that more data are needed to define ability to repay and determine the percentage of a consumer's paycheck that is adequate. The term loan structure must also factor in credit performance when underwriting.

Participants perceived that banks have little room to experiment and test different data points without regulatory risk. Finally, some participants added that banks and other small-dollar credit providers should have an even playing field; if banks have to underwrite then payday lenders should have to underwrite too. Other participants argued that payday lenders are not a good model for banks. Banks know more about the consumer, how to manage risk, lend over longer periods of time, and segment consumers.

Other challenges participants highlighted relate to "cooling off periods" and segmenting consumers. Some participants noted that cooling off periods, which prohibit further borrowing for a set period if customers reach a limit for indebtedness (either time in debt or number of loans taken), are not acceptable to the consumer and hurt bank-consumer relationships. But, as one participant added, from another perspective, a product that works for consumers should not need a cooling off period. The challenge raised with being mindful of the consumer's context is that segmenting consumers can raise regulatory or examiner concerns. This concern can be an obstacle to developing multiple products and directing consumers to products that are appropriate for them, or providing consumers with choices. Other participants wondered if having one product but different messaging based on the consumer's situation was a solution. But product simplicity was also highlighted during the day as a consumer need; consumers like simple, transparent products, and options that are complex can make the consumer experience worse.

Conclusion

Developing new financial products is an iterative process. While recent research has shed light on small-dollar credit consumers and the needs they face, creating profitable products and effective underwriting methods to provide credit quickly where appropriate will take time. Technological innovations could speed the process. Credit unions and other groups have piloted product features showing some success, but the challenge of scaling these products and continuing to understand the types of products and features that are likely to raise regulatory concerns remains.

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