AMERICAN FINANCIAL SERVICES ASSOCIATION

AN EMERGING CONSENSUS:
THE NEED FOR HIGH QUALITY SMALL LOAN PRODUCTS
AND THE FORM THEY SHOULD TAKE

1. THERE IS A REAL NEED AND DEMAND FOR SMALL DOLLAR CREDIT

“In both rich and poor countries alike, credit institutions have favored the rich and in so doing, have pronounced a death sentence on the poor…If economists would only recognize the powerful socio-economic implications of credit, they might recognize the need to promote credit as a HUMAN RIGHT.”

- *Muhammad Yunus, Banker to the Poor (1999)*

“…. Business men could call on bankers for their business and personal needs, while blue-collar and lower-level white-collar workers were forced to borrow money from shadowy lenders, at high rates, under illegal conditions. This state of affairs compromised democratic standards of fairness and reformers of the Progressive Era were not blind to it.”

- Lendol Calder, Financing the American Dream (1999)

"Despite some innovation and a handful of new products over the last few years, the gap between supply and demand is greater than ever."

[And]

"Income supports, budgeting guidance and additional savings will not entirely fill the need that credit satisfies. Well-structured credit can help build a credit history; facilitate an investment or purchase that provides the foundation for other wealth-building activities; and support a family's ability to save."[1]

- Jennifer Tescher, Center for Financial Services Innovation (CFSI) (2010)

“Personal installment loans are often a critical lifeline for borrowers with limited credit options, allowing them to pay for unexpected expenses or to consolidate debts.”

- Assistant Attorney General Bill Baer, Justice Department Antitrust Division (2015)

2. THE KEY TO QUALITY SMALL LOANS IS STRUCTURE, NOT RATE

“We recognize the need for emergency credit. At the same time, it is important that these products actually help consumers, rather than harm them.”[2]

- Richard Cordray, CFPB, Birmingham, AL (Jan 2013)

“…. Much of the debate about small-dollar credit has heretofore focused on price, as expressed in Annual Percentage Rates (APR), as a primary determinant of quality. While affordable prices are certainly one aspect of high-quality small-dollar loans, what is “affordable” to any given borrower depends on many factors, including the loan’s size, repayment period, interest rate and fees, as well as the individual borrower’s unique financial situation….”

- Center for Financial Services Innovation (CFSI)

"…high-quality small-dollar, short-term credit…. must be affordable and structured to support repayment—without creating a cycle of repeat borrowing or "rolling over" of the loan—and repayment must be reported to the credit bureaus"[3]

- Center for Financial Services Innovation (CFSI)

"Safeguards are needed to create successful small-dollar loan markets. Ensuring that borrowers can repay loans in installments over time will help alleviate the harms of payday lending. But unless policymakers also ensure that loans are structured according to the borrower's ability to repay—and protect against lender driven refinancing, noncompetitive pricing, excessively long loan lengths, and abusive repayment or collection practices—consumers will remain at risk."[4]

- Pew Charitable Trusts

3. PRODUCTS MUST BE SUSTAINABLE AND LENDERS MUST BE ALLOWED TO MAKE A FAIR PROFIT

"Installment lending can enable both lenders and borrowers to benefit. If borrowers repay as scheduled, they can get out of debt within a manageable period and at a reasonable cost, and lenders can earn a pro t. This differs dramatically from the payday and auto title loan markets, in which lender profitability hinges on unaffordable payments that drive frequent borrowing. However, to realize this potential, states would need to address substantial weaknesses in laws that lead to problems in installment loan markets."

- Pew Charitable Trusts[5]

"At the heart of the Compass Principles is a commitment to mutual success in the customer-provider relationship. By reframing each customer interaction as a source of many future engagements, and aligning company culture and incentives accordingly, providers can successfully and profitably offer, structure, and sell products and services that promote a positive customer relationship.

In the case of small-dollar credit products, it means designing business models and products such that the lender's profitability depends on borrowers' success with the product (i.e. high rates of on-time repayment, low default rates, etc.) without re-borrowing and while still meeting basic needs and other financial obligations; a high default rate should never be accepted as just another cost of doing business."

[And]

"…lenders must be able make a profit in order to offer consumers lasting, high-quality solutions at scale. However, small-dollar credit products should not benefit the lender at the borrower's expense; in other words, the business model should rely on successful repayment, not high probabilities of default." [6]

- Center for Financial Services Innovation (CFSI) Compass Principles

"A lower rate had proved insufficient to provide capital needed to meet the demand for loans in the small cities...The new rate was based upon... the necessary costs of operation and was keyed to the business of the lender of average capital in the moderate-sized cities."

[And]

"…a desire to do justice to both borrower and lender. It recognized the fact that small-loan agencies, unlike banks, have no deposits, that their security is not substantial or fluid…that small loans on chattel mortgage...require more investigation than bank loans; that installment repayments necessitate a large bookkeeping and collecting system, and that reputable capital would not come into the business unless it could see the prospect of profit above the necessarily high overhead cost."

- Arthur Ham, Address to Industrial Lenders Conference (1923)

4. THE ART OF REGULATION: STRIKING THE BALANCE

"…we are trying to make sure there is room for responsible lending... [including] installment lenders that are traditional and have responsible products… it's a tough balance and that's why it's been difficult rulemaking"[7]

- Richard Cordray, Director Consumer Financial Protection Bureau, CFPB (2015)

"Interest rate ceilings hurt poor people by making it harder for them to get credit. Making many small loans costs more than making a few large ones. Interest rate ceilings prevent microfinance institutions from covering their costs, and thereby choke off the supply of credit for poor people."[8]

- Good Practice Guidelines for Funders of Microfinance, CGAP (October 2006)

"The main thrust of the truth-in-lending bill is to promote more effective price competition in the consumer credit industry. As you know, competition is the essence of our free enterprise system. The workings of the competitive market insure that consumers will be able to obtain the kinds of goods they want at the lowest possible price."

- Senator William Proxmire (D-WI)

"…. the Department has learned of the potential for unintended consequences that could adversely affect credit availability if it were to adopt a broadly applicable regulation…"

[And]

"Isolating detrimental credit products without impeding the availability of favorable installment loans was of central concern in developing the regulation. Consequently, installment loans that do not fit the definition of "consumer credit" in Section 232.3(b), including the definition of "payday loans," "vehicle title loans," or "tax refund anticipation loans" are not covered by the regulation."

[This ruling was in recognition of the fact that:]

"The intent of the statute is clearly to restrict or limit credit practices that have a negative impact on Service members without impeding the availability of credit that is benign or beneficial to Service members and their families."

- US Department of Defense, Final Rule on John Warner National Defense Authorization Act (2007)

"As a general rule, interest rate controls may hinder access to formal financial services, especially for lower income segments, unless rates are set at sustainable commercial levels that permit providers to cover the typically higher transaction costs…"[9]

- Consumer Protection Regulation in Low-Access Environments, CGAP (February 2010)

"What kind of government interventions can harm the development of microfinance? Interest rate ceilings, provision of credit (directly by government entities) at the retail level, subsidized lending…and political interference."[10]

- The Role of Governments in Microfinance, CGAP (June 2004)

"The object...was to...regulate rather than to annihilate the business; to secure the enforcement of such laws and oppose the passage of drastic, impractical laws..."

[And]

"If borrowing under the law is limited by impossible restrictions, then both the borrower and lender will defy the law and take their chances on its being enforced. In the end the borrower always pays the price in high interest charges."

[And]

"This plan was based on a recognition of the small-loan business, not as a parasitic growth but as a necessary element in our financial system, and on a desire to attract into the business reputable capital which should furnish the sort of competition necessary to keep profits within reasonable limits.

It was our aim from the start to dissociate the small loan business from the character of some of those engaged in it; to show that it was the practice of the loan sharks and not the need for loans which was disreputable."

- Arthur Ham, Address to Industrial Lenders Conference (1923)

… [National Black Caucus of State Legislators] NBCSL supports lending that protects consumers by encouraging responsible underwriting, and assessing a borrower's ability and willingness to repay the loan at a reasonable rate;

…. NBCSL encourages financial service organizations that offer lending services to the elderly and service members take the following into account:

- that lenders should examine factors like a borrower's credit bureau reports, the availability of monthly income for debt service, and the amount of the borrower's debt compared to assets and income as a condition for making a loan…
- that any loan should be structured in such a way as to minimize the danger that a borrower might fall into the cycle of debt;[11]
  - National Black Caucus of State Legislators (NBCSL) Resolution (2014)

5. CHARACTERISTICS OF BAD OR DANGEROUS PRODUCTS

"While more than half of payday borrowers repay their loans within two weeks, a significant number of consumers rollover, renew or extend their loans multiple times. Our study found that the average payday consumer takes 11 loans or extensions per year and is in debt for approximately 150 days."[12]

- Rob Schneider and Rob Levy, Center for Financial Services Innovation (CFSI) in *American Banker*

More than 80% of payday loan borrowers cannot afford to repay the loan in full at the end of the initial two-week term."[13]

- Pew Charitable Trusts

"By requiring repayment in full after only two or four weeks, payday loans can cause a toxic cycle-of-debt at an ultimate cost that far outweighs the original loan amount."[14]

- Jennifer Tescher, Center for Financial Services Innovation (CFSI) (2007)

"Cycle of debt represents a more significant concern to the Department than the high cost of credit."[15]

- US Department of Defense, Final Rule on John Warner National Defense Authorization Act (2007)

"…. the current repayment structure of payday loans and deposit advances, coupled with the absence of significant underwriting, likely contributes to the risk that some borrowers will find themselves caught in a cycle of high-cost borrowing over an extended period of time. As we have seen, payday loans are generally required to be repaid at the consumer's next payday…Yet, it does not appear that lenders attempt to determine whether a borrower meets this profile before extending a loan. Lenders may instead rely on their relative priority position in the repayment hierarchy to extend credit without regard to whether the consumer can afford the loan. This position, in turn, trumps the consumer's ability to organize and prioritize payment of debts and other expenses. Other structural and usage characteristics may also play a material role in harms experienced by consumers."

- Payday Loans and Deposit Advance Whitepaper, Consumer Financial Protection Bureau (CFPB) (2013)

“Payday loans, deposit advances, auto [title] loans, and pawn loans are predatory”

[And]

“Congress can ensure that the cycle of debt is broken for borrowers by requiring all loans to be fully amortized with no balloon payments….”

[Congress should] “Prohibit mandatory check holding and automatic bank withdrawals, particularly for deposit-advance loans from banks. In the current market, many lenders require the borrower to provide a post-dated check or written permission to automatically withdraw money from the borrower’s bank account. This can trigger overdrafts fees for the borrowers, effectively raising the cost of the loan.” [16]

- Corporation for Enterprise Development (CFED) (2014)

6. CHARACTERISTICS OF HIGH QUALITY PRODUCTS

“[Installment loan] Monthly payments are usually affordable, with approximately 85 percent of loans having installments that consume 5 percent or less of borrowers’ monthly income. Previous research shows that monthly payments of this size that are amortized—that is, the amount owed is reduced— fit into typical borrowers’ budgets and create a pathway out of debt.

- Pew Charitable Trusts[17]

“This Guide emphasizes responsible underwriting as a key component of a high-quality small-dollar credit product.”

[And]

“This Guide defines a high-quality small-dollar loan as one that:

- Is made with a high confidence in the borrower’s ability to repay
- Is structured to support repayment
- Is priced to align profitability for the provider with success for the borrower
- Creates opportunities for upward mobility and greater financial health
- Has transparent marketing, communications, and disclosures
- Is accessible and convenient
- Provides support and rights for borrowers.”

- *The Compass Guide to Small-Dollar Credit* (CFSI, February 2014):[18]

…the key structural qualities of loans that are safe and affordable are that the lender makes a good faith effort to assess the borrower’s ability to repay the loan and that the loan is repayable in substantially equal installments of principal and interest, with no balloon payments; and

…NBCSL's intention is to ensure access to loans that are low cost rather than low rate."[19]

- National Black Conference of State Legislators (NBCSL) Resolution (2014)

"Payday borrowers strongly support requiring the loans to have affordable installment payments. Eight in 10 favor a requirement that payments take up only a small amount of each paycheck, and 9 in 10 favor allowing borrowers to pay back loans in installments over time." [20]

- Pew Charitable Trusts

"CFSI's research suggests that developing [SAFER] products requires satisfying a tall order of criteria. This criteria starts with budgeting and advice and savings, and then when credit is the right solution, balancing sound underwriting to determine ability to repay with speed, convenience and accessibility."

- Center for Responsible Lending (CRL)

"Responsible alternatives to payday loans should have these features: At least a 90-day repayment term, repayable in installments; No personal check mechanism or other unfair collateral (such as a car title); Reasonable limits on renewals (If borrowers are renewing short-term loans more than four times per year, the loans are not helping them); Full consideration of borrower's ability to repay the loan; No mandatory arbitration clause."[21]

- Center for Responsible Lending (CRL)

"Installment loans are an important part of your credit report. The payment history on your loans, how long you have had them, the types of loans you receive and how much debt you have all influence on your credit scores."

[And]

"A rich history of on-time installment loan payments will be reflected in good credit scores, even if you don't have a credit card."

[And]

"However, you can build a good credit history that will be reflected in good credit scores, without a credit card. Consistently making on time payments on installment loans, such as a car loan, demonstrates that you are a reliable borrower."

- Experian Website (www.experian.com)

"In general, having credit cards and installment loans (and paying timely payments) may favorably impact your credit score in the long term"

- Equifax Website (www.equifax.com)

"Credit building is the only way someone with a thin (or absent) credit profile can establish or re-establish a credit score. On-time payments – even for small loans – can help individuals increase their credit scores by an average of 35 points – moving an individual with no score to a prime credit score."

[And]

"The report, which surveyed… more than 1,000 consumers, found that 50 percent of consumers would be more likely to pay utility and telecommunications bills on time if they knew that payment data was reported to the credit bureaus."[22]

- What if People got the Credit They Deserve (CFSI and Credit Builders Alliance)

7. WHERE PAYDAY IS THE PROBLEM, INSTALLMENT CAN BE THE SOLUTION

"[Installment loan] Prices are far lower than those for payday and auto title loans. For example, borrowing $500 for several months from a consumer finance company typically is three to four times less expensive than using credit from payday, auto title, or similar lenders."

- Pew Charitable Trusts[23]

"Unlike many other states, Texas' thriving signature loan industry provides a clearly safer and more affordable alternative to high-risk, high-cost payday loans" [24]

- Consumers Union (2003)

"…. far from tempting the poor into unpayable debt, installment lenders help them to keep their jobs, put food on the table and build up a credit history."

- "In Praise of Usury" *Economist* (August 2007)

"Because consumers must deliberately decide to apply for installment loans, some planning and intentionality is required of borrowers. The fact that installment loans are offered at a fixed rate and are paid back in equal payments may help to ensure that the loan remains an affordable part of a consumer's budget"[25]

- Center for Financial Services Innovation (CFSI)

8. MANY STATE LEGISLATORS UNDERSTAND THE VALUE AND ROLE OF TRADITIONAL INSTALLMENT LOANS

[In 2013, both the National Black Caucus of State Legislators and the National Hispanic Caucus of State Legislators passed resolutions promoting safe and affordable lending practices. These resolutions are excerpted here.]

WHEREAS, in 1998, the United Nations defined poverty as the lack of access to certain essential goods and services, including access to credit;

WHEREAS, the need for small-dollar credit exists in every community throughout the country;

WHEREAS, not all loan types are equally safe and affordable, and the structure of certain loans significantly increases the likelihood of borrowers falling into a cycle of debt;

WHEREAS, responsibly structured credit is essential to support a household's ability to save, build a sound credit history, and facilitate crucial investments that can provide a foundation for other wealth-building activities;

WHEREAS, the key structural qualities of loans that are safe and affordable are that the lender makes a good faith efforts to assess the borrower's ability to repay the loan and that the loan is repayable in substantially equal installments of principal and interest, with no balloon payments;

WHEREAS, it is the intention of this body to ensure access to loans that are low cost rather than low rate, since consumers buy goods with dollars and cents and not with annual percentage rates;

WHEREAS, it is important that safe and affordable small-dollar loans be made from offices located within communities and licensed and audited by state authorities to protect from predatory lenders and lending practices.

THEREFORE, BE IT RESOLVED, that the National Black Caucus of State Legislators (NBCSL) supports the development of lending products that encourage responsible underwriting, and attempts to assess a borrower's stability, ability, and willingness to repay the loan;

BE IT FURTHER RESOLVED, that NBCSL encourages policymakers to take the following into account:

- that lenders should examine factors like a borrower's credit bureau reports, the availability of monthly income for debt service, the length of time the consumer has been gainfully employed, and the amount of the borrowers' debt compared to assets and income as a condition for making a loan;
- that lenders should support and observe all applicable state laws regarding collection practices and that they should make good faith attempts with borrowers to remedy a delinquent account;
- that any loan should be structured in such a way as to minimize the danger of that a borrower might fall into the cycle of debt;
- that lenders take care to explain to borrowers, the terms of a possible loan transaction in as clear and transparent a manner as possible;
- that lenders should be a vital part of the communities in which they operate and actively participate in community activities and charitable endeavors;
- that lenders should support and participate in financial literacy programs by contributing financially to organizations that offer these services to borrowers; and
- that lenders, non-profit organizations, and government entities should work together to improve financial literacy;

\- National Black Conference of State Legislators (NBCSL) Resolution (2013) and National Hispanic Caucus of State Legislators (NHCSL) Resolution (2013)

9. CFPB FINAL SMALL DOLLAR RULE (OCTOBER 5, 2017)[26]

"In general, the Bureau proposed to incorporate a number of defined terms under the Dodd-Frank Act and under other statutes or regulations and related commentary, particularly Regulation Z and Regulation E as they implement the Truth in Lending Act (TILA)422 and the Electronic Fund Transfer Act (EFTA),423 respectively. The Bureau believed that basing the proposal's definitions on previously defined terms may minimize regulatory uncertainty and facilitate compliance, especially where the other regulations are likely to apply to the same transactions in their own right."

- Page 190

"The Bureau has concluded that defining the term cost of credit consistently with Regulation Z would reduce the risk of confusion among consumers, industry, and regulators. It also reduces burden and avoids undue complexities."
- Page 200

"As described above in connection with the definition of cost of credit in § 1041.2(a)(6), the Bureau has decided to relax the rate threshold in the final rule by basing the threshold on the annual percentage rate as defined in Regulation Z rather than the total cost of credit concept used in the Military Lending Act. The final rule retains the numeric threshold of 36 percent, however, 253 since, as the proposal explained more fully, that annual rate is grounded in many established precedents of Federal and State law."
- Page 252-253

"In the Military Lending Act rule limiting the terms of consumer credit extended to Servicemembers and their dependents, the Department of Defense noted its unwillingness to define the total cost of credit so as to exclude "certain fees, or all non-periodic fees, [which] could be exploited by a creditor who would be allowed to preserve a high-cost, open-end credit product by offering a relatively lower periodic rate coupled with an application fee, participation fee, or other fee." 80 FR 43563. Under the cost of credit adopted here from Regulation Z to govern the applicability of subpart C to covered lenders, the Bureau would note that if a lender sought to structure its loans in such a manner as to shift the cost of credit from the periodic rate to unusual application fees, participation fees, or other fees that bore no relation to the actual cost of credit in order to avoid coverage under this rule, then supervisory or enforcement authority could be invoked and this structuring of the loans could be cited as evidence of attempted evasion of the rule."
- Page 980

[1]http://www.cfsinnovation.com/sites/default/files/Column%20Small%20Dollar%20Credit%20in%20Short%20Supply.pdf
[2] http://www.consumerfinance.gov/newsroom/remarks-by-richard-cordray-at-the-payday-loan-field-hearing-in-birmingham-al/
[3] http://www.cfsinnovation.com/system/files/Research_Paper_Credit_Symposium_April62010.pdf
[4] http://www.pewstates.org/uploadedFiles/PCS_Assets/2013/Pew_Payday_Overview_and_Recommendations.pdf
[5] https://www.pewtrusts.org/-/media/assets/2018/10/installment-loans_report.pdf
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