Affordable Small-Dollar Loan Guidelines

The purpose of these guidelines is to encourage financial institutions to offer small-dollar credit products that are affordable, yet safe and sound. Because such products are in great demand, the FDIC would like to raise awareness that some institutions have found ways to offer them in a cost-effective, safe and sound manner that is responsive to customer needs. Furthermore, such products offered in a responsible, safe and sound manner will warrant favorable Community Reinvestment Act (CRA) consideration.

These guidelines explore several aspects of product development, including affordability and underwriting. They also discuss tools, such as financial education and savings, that may address long-term financial issues that concern borrowers.

Demand for Affordable, Reasonably Priced Small-Dollar Loans – An Opportunity for Financial institutions

The widespread repeat use of fee-based overdraft programs and the growth of payday lending[1] confirm that loans in small-dollar amounts are in strong demand. Consumers who make use of these products are bank customers because both products typically require consumers to have a checking account. Providing more reasonably priced small-dollar loans to existing customers can help banks retain these customers and avoid the reputation risk associated with high-cost products.

In addition, affordable short-term loan programs, particularly those offered to low- and moderate-income individuals and in low- and moderate-income areas, may be used as a marketing vehicle to tap into the underbanked market. This strategy has been pursued by some financial institutions as one important part of a profitable, long-term, multiple account relationship for these individuals that may also include financial education, workplace financial services, individual development savings accounts, foreign remittances, and other services.

Applicability of Subprime Lending Guidance to Affordable Small-Dollar Loan Programs

The FDIC recognizes that an affordable small-dollar loan program may target customers who have poor or limited credit histories, or who would otherwise be characterized as subprime borrowers. However, the interagency Expanded Guidance for Subprime Lending Programs[2] limits the definition of subprime lending as a program with an aggregate credit exposure greater than or equal to 25 percent of Tier 1 capital. Accordingly, affordable small-dollar loan programs that fall under the 25 percent of Tier 1 capital threshold would not be expected to provide the additional capital or robust monitoring and portfolio analysis called for in the Subprime Guidance. Given the nature of affordable small-dollar loan programs, the FDIC expects that such programs typically would fall under this threshold.

Features of Responsible, Affordable Small-Dollar Credit Programs

Some small-dollar loan programs are designed for the broad base of customers. Others are targeted to certain markets, such as low- and moderate-income customers, the under-banked, or customers with a limited or non-existent credit history. Still other programs are developed to address the regulatory expectation articulated in prior guidance that financial institutions monitor customer use of products such as fee-based overdraft programs and, when usage becomes excessive, offer or refer a customer to a more suitable product.[3] The goal of all of these programs is to enable insured institutions to tap into an underserved and potentially profitable market while helping consumers avoid, or transition away from, reliance on high-cost debt.

The goal of safe and sound small-dollar credit programs is to provide customers with credit that is both reasonably priced and profitable for the institution. Fundamentally, credit should be provided in a manner that offers borrowers a meaningful opportunity to repay debt based on their circumstances and other outstanding obligations. Where closed-end credit is offered, it should also be structured to be repaid in affordable installments within a specified period. Where open-end credit is offered, products should be structured to require minimum payments of interest and principal that provide for the reduction of the outstanding loan over a reasonable timeframe. New products should be appropriate for the group of customers targeted, as well as compliant with all applicable laws.[4]

Over time, borrowers should be able to improve their credit histories and graduate to other more significant asset-building loans, such as home mortgages and small business loans. Some standard products, such as lines of credit and closed-end installment loans, can be offered with features that make them particularly responsive to borrower needs.

Affordability and Pricing

Lenders are encouraged to offer credit products with interest rates and fees that reflect associated risks, but remain affordable. To maintain a reasonable annual percentage rate (APR) and cover administrative and other expenses, an origination fee that bears a direct relationship to origination costs might be assessed. However, to help ensure that borrowers reduce outstanding principal, lenders are encouraged to minimize or eliminate charges such as annual fees, membership fees, advance fees, and prepayment penalties.

Pricing may vary depending on the risk profile of the target group. For example, a number of institutions have developed affordable small-dollar credit programs with APRs that range between 12 percent and 32 percent with no or low fees. We encourage lenders to offer small-dollar credit with APRs of 36 percent or less.

Encouraging Principal Reduction

Institutions are encouraged to structure payment programs in a manner that fosters the reduction of principal owed. For closed-end products, loans should be structured to provide for affordable and amortizing payments. Open-end products should require

minimum payments that pay off principal. However, excessive renewals of a closed-end product, or the prolonged failure to reduce the outstanding balance on an open-end loan, are signs that the product is not meeting the borrower's credit needs.

Streamlined, Risk-Based Underwriting

Many consumers turn to payday loans and overdraft programs because these products are easily accessible and generally are more widely promoted than other more traditional, affordable loans. For many borrowers with emergency or other short-term needs, accessibility and expediency in the application process are important.

Effective small-loan products balance the need for quick availability of funds with the fundamentals of responsible lending. Sound underwriting criteria should focus on a borrower's ability to repay a loan. Given the small-dollar amounts of each individual loan, documenting the borrower's ability to repay could be streamlined significantly for existing customers and may only need to include very basic information, such as proof of recurring income.

Insured institutions have the advantage of a pre-established relationship with most of the customers who now rely on non-bank lenders for short-term, high-cost credit. Community banks often know their customers' credit needs because of frequent personal contact and awareness of the local economic situation. Relying on this internally obtained information can be particularly helpful not only in increasing application turnaround, but in assisting consumers with little or no credit history obtain credit that they both need and can repay.

Maximization of Technology and Automated Processes

Institutions may also rely on various automated programs that provide information on client usage of the bank's products and services, generating performance profiles that are useful in underwriting decisions. The use of existing platforms and technologies can lower the cost of providing small-denomination credit and make such programs economically feasible for insured institutions. For example, a bank could establish a line of credit facility at the time a deposit account is opened, to be subsequently activated upon proper maintenance of the deposit account relationship for a specified period, for example, six months. Some financial institutions with successful small-dollar loan programs use existing automated telephone banking systems, in-branch automated underwriting, and online applications for quicker, less expensive service. Finally, voluntary preauthorized transfers may help borrowers make regular payments.[5]

Savings Component

Institutions may consider structuring small-dollar loan programs to include a savings component. For instance, borrowers could be required to set aside a percentage of the amount that they borrow in a designated savings account. The funds in this account can serve as a pledge against the loan, as permitted by law, and withdrawals

from the savings account can be restricted to require authorization by a lending official. This approach encourages borrowers to create savings that lessen their reliance on short-term financing to meet unexpected needs. From the institution's perspective, it helps cultivate a banking relationship in which other financial services can be offered to the customer in the future. Some banks may choose to combine the borrowers' funds with matching funds from a nonprofit or public agency through an Individual Development Account.

Collaboration with Other Financial Institutions and Organizations

Collaboration with other financial institutions or organizations, both for-profit and not-for-profit, may assist a financial institution to develop and implement a small-dollar loan program for its community. Some lenders have received grants from larger institutions to create loan loss reserves in an effort to provide more lending power to their small-dollar loan programs. Others rely on referrals from community organizations to identify borrowers. Some have developed alliances with alternative financial service providers in an effort to reach out to the unbanked and underbanked, with the aim of transitioning these individuals to asset-building products and more mainstream banking services.

Financial Education

Improving financial skills can help consumers reduce reliance on short-term credit. Moreover, institutions that monitor borrower use of credit and offer financial counseling or education when signs of financial stress are detected will help them become better bank customers and improve long-term customer relationships.

Financial institutions may wish to work with non-profit agencies and organizations that provide financial education training, such as reputable consumer credit counseling agencies. Budget management is an important strategy for borrowers. With it, they can eliminate unnecessary spending and focus their attention on meeting their financial obligations and saving for future expenditures.

Community Reinvestment Act Consideration for Small-Dollar Loan Programs

Establishing a loan program in a bank's assessment area that provides small, unsecured consumer loans that are consistent with these guidelines would warrant favorable consideration under the CRA as an activity responsive to the credit needs of the community.[6]

Conclusion

Affordable small-dollar loans are in demand. Many consumers turn to payday or other lenders because they are accessible and can quickly provide loans. Yet, the inability to repay these short-term, high-cost credit products often exacerbates a customer's ability to meet cash flow needs. Financial institutions can provide the same service with more appropriate loan terms and at a lower cost, and some institutions have found creative

ways to do so. The FDIC encourages institutions to consider opportunities for offering innovative, reasonably priced products that meet this need.

---

[1] Payday loans are short-term loans, generally less than $500, for which a borrower has given a check postdated to the borrower's next payday, when the full balance of the loan is due.

[2] **See** Subprime Lending: Expanded Guidance for Subprime Lending Programs, FIL-9-2001 (January 31, 2001), http://www.fdic.gov/news/news/press/2001/pr0901a.html.

[3] The federal financial institution regulatory agencies have recommended that when overdraft protection is used excessively, customers should be informed of other credit products that may be better suited to their needs. **See** Joint Guidance on Overdraft Protection Programs, FIL-11-2005 (Feb. 18, 2005), http://www.fdic.gov/news/news/financial/2005/fil1105.html#body.

[4] Products offered to covered military service members and their dependents must comply with the limitations found in the Talent-Nelson Amendment, enacted as section 670 of the John Warner National Defense Authorization Act for Fiscal Year 2007. The Talent Amendment establishes a number of limitations on extensions of credit to covered service members and their dependents, including restrictions on interest, types of security, prepayment penalties and other terms and conditions. The Talent Amendment becomes effective on October 1, 2007.

[5] Pursuant to Federal Reserve Board Regulation E, which addresses Electronic Fund Transfers, borrowers cannot be required to make payments in this manner unless credit has been extended under an overdraft credit plan. **See** 12 C.F.R. 205.10(e).

[6] **See** Interagency Questions and Answers on the Community Reinvestment Act, 66 Fed. Reg. 36619, 36631, Sec.345.22(a)-1 (July 12, 2001), http://www.fdic.gov/news/news/inactivefinancial/2001/fil0164.html. The federal banking agencies confirmed that establishing loan programs that provide small, unsecured consumer loans in a safe and sound manner (i.e., based on the borrower's ability to repay) and with reasonable terms may warrant favorable consideration as activities that are responsive to the needs of the institution's assessment area(s). While this clarification refers to the CRA lending test for large institutions (institutions with assets over $1 billion), the FDIC takes a similar view for all other institutions.