Financial Institution Letter FIL-50-2007
June 19, 2007

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, and consistent with all applicable federal and state laws. 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.

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. Moreover, the guidelines address the FDIC's examination treatment of affordable small-dollar lending programs. Safe and sound small-dollar lending programs that comply with consumer protection lawSs will not be criticized by FDIC examiners. Importantly, the FDIC recognizes that the Community Reinvestment Act (CRA) provides a valuable incentive to offer affordable small-dollar loans. Institutions that provide such products consistent with these guidelines will receive favorable CRA consideration as outlined in the CRA section below.

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 institution customers because both products typically require consumers to have a checking account. Providing more reasonably priced small-dollar loans to existing customers can help institutions retain these customers and avoid the reputation risk associated with high-cost products.

In addition, affordable short-term loan programs, particularly those offered to LMI individuals and in LMI 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 need to serve 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. Given the nature of affordable small-dollar loan programs, the FDIC expects that such programs typically would fall under this threshold and would not warrant unusual examination scrutiny.

Features of Responsible, Affordable Small-Dollar Credit Programs

Some small-dollar loan programs are designed for a broad base of customers. Others are targeted to certain markets, such as military customers, employers, LMI customers, the underbanked, or customers with a limited or non-existent credit history. Still other programs are developed to address the regulatory recommendation 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 these programs is to enable insured institutions to better serve an underserved and potentially profitable market while helping consumers avoid, or transition away from, reliance on high-cost debt.[4]

When used comprehensively, the features described below can help institutions meet the goal of safe and sound small-dollar credit programs, which is to provide customers with credit that is both reasonably priced and profitable. 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. For example, lines of credit may be more responsive to individuals who need immediate access to credit when emergencies arise and prefer conducting such transactions privately. 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. Where closed-end credit is offered, it should be structured to be repaid in affordable installments within a specified period. New products should be appropriate for the group of customers targeted, as well as compliant with all applicable laws.[5] Most importantly, however, credit should be provided in a manner that offers borrowers a meaningful opportunity to repay based on their circumstances.

Over time, borrowers should be able to improve their credit histories and graduate to other more significant asset-building loans, such as home mortgage loans and small business loans. We encourage institutions to make borrowers aware that they offer such products.

- *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. As permitted by state law, we encourage lenders to offer small-dollar credit with APRs no greater than 36 percent.

- *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[6], 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 history with the institution and ability to repay a loan within an acceptable timeframe. 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-insured lenders for short-term, high-cost credit. Community institutions 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 improving 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 institution'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 instance, an institution 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 period of time, such as several 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.[7]

- *Savings Component*
  Institutions may consider structuring small-dollar loan programs to include a savings component. For instance, a portion of a borrower's regular payment could be deposited into a savings account, or borrowers could set aside a percentage of the amount that they borrow in a designated savings account. The funds in this account could also serve as a pledge against the loan, as permitted by law. This approach encourages borrowers to create regular 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 institutions may offer borrowers the option of combining their deposits with matching funds from a nonprofit or public agency through an Individual Development Account program.

- *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. Some lenders may help fund a revolving loan pool administered by another lender or community-based organization. Others rely on referrals from community organizations to identify borrowers. Some have developed alliances with non-profits, social service agencies and employers 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 high-cost 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 these borrowers become better customers and improve long-term 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

Under interagency guidance, examiners may favorably consider small-dollar loan programs when evaluating the lending performance of small, intermediate-small, and large institutions. While credit needs vary from community to community and no one activity results in an examination rating, the Federal banking agencies have recognized that some activities, such as making affordable small-dollar loans, are likely to be particularly responsive in helping to meet the credit needs of many communities.[8] To be considered, small dollar loan programs should be made generally available and result in loans to individuals across different income levels, including low- and moderate-income individuals.[9] A small-dollar loan program may not be large quantitatively compared to some other lending programs offered by an institution. Nevertheless, a small-dollar loan program may be uniquely responsive to a compelling need for an alternative to high cost credit and, therefore, have significant impact qualitatively. It is this qualitative consideration of a small loan program that may strengthen an institution's lending performance to help achieve a Satisfactory rating, or to the extent performance exceeds Satisfactory standards, to help achieve an Outstanding rating.[10]

The Federal banking agencies have also emphasized that programs that transition borrowers from higher cost loans to lower cost loans are particularly responsive to community needs.[11] Consequently, offering lower cost alternatives to such borrowers also will be viewed as responsive in the CRA examination.[12]

Some small-dollar loan programs may also qualify for favorable consideration under the community development service criteria.[13] These include small dollar programs that, for example, may include: 1) a low-cost checking or savings account; 2) financial education that includes a component on how to avoid lending that may be abusive or unsuitable; or 3) free government and payroll check cashing that increases access to financial services for lower income individuals.

Conclusion

Affordable small-dollar loans are in demand. Many consumers turn to high-cost non-bank lenders because they are accessible and can quickly provide these loans. Yet, the inability to repay these short-term, high-cost credit products often leads to costly renewals and exacerbates a customer's difficulties in meeting 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. In addition, affordable, small-dollar loan products coupled with a savings component can lead to profitable, long-term customer relationships. Affordable small loan programs also receive favorable consideration during CRA examinations. The FDIC encourages institutions to consider opportunities for offering innovative, reasonably priced products that meet this need.

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[1] Payday loans are small dollar, short-term loans, 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 (February 18, 2005), http://www.fdic.gov/news/news/financial/2005/fil1105.html#body.

[4] During the December 6, 2006 FDIC Conference, "Affordable, Responsible Loans for the Military: Programs and Prototypes," attendees developed a template for an affordable, small-dollar loan program. Conference participants agreed that the range of options it sets forth would be useful in developing a responsible small-dollar loan program suitable for both an institution and its military customers. **See** http://www.fdic.gov/news/conferences/militaryloans/Military_Small_Dollar_Loan_Template.pdf - PDF (PDF Help)

[5] 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. (Pub. L. No. 109-364, 120 Stat. 2266-2269.) The Talent-Nelson 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-Nelson Amendment becomes effective on October 1, 2007. The Department of Defense is to promulgate regulations implementing the Talent-Nelson Amendment by that date. These regulations are expected to further define the type of credit to which these restrictions apply.

[6] We encourage institutions to utilize a reasonable time frame for the repayment of closed-end credit, e.g., at least 90 days. This should enable borrowers to repay the debt without incurring the cost of multiple renewals.

[7] Pursuant to Federal Reserve Board Regulation E, which implements the Electronic Fund Transfer Act, 15 U.S.C. 1693 et seq., a financial institution is permitted to condition an extension of credit to a consumer on the consumer's repayment by preauthorized electronic fund transfers [i.e., by electronic means on a preauthorized, recurring basis], if the credit has been extended under an overdraft credit plan or to maintain a specified minimum balance in the consumer's account. **See** 12 C.F.R. § 205.10(e). In addition, the Official Staff Commentary to Regulation E makes clear that a creditor "may offer a program with a reduced annual percentage rate or other cost-related incentive for an automatic repayment feature, provided the program with the automatic payment feature is not the only loan program offered by the creditor for the type of credit involved." **See** Paragraph 10(e) (1)-Credit to Supplement I of Regulation E.

[8] **See** Interagency Questions and Answers (Q&As) for CRA, 66 Fed. Reg. 36619, 36631, §_.22(a)-1 (July 12, 2001), http://www.ffiec.gov/cra/pdf/qa01.pdf - PDF 285k (PDF Help).

[9] To help limit costs to financial institutions, FDIC examiners will consider information provided on such small-dollar loan programs even though the institution may not have provided other information on consumer loans under data collection requirements. **See** 12 C.F.R. §345.42.

[10] **See** Interagency Q&As for CRA at §_.28-1 & .28.-2.

[11] **See** Interagency Q&As for CRA at §_.22(a)-1.

[12] **Id.**

[13] **Id.**, at §_.12(i) -3.