

How Should We Serve the Short-Term Credit Needs of Low-Income Consumers?

Introduction

Almost one-third of the 30 million U.S. households who are unbanked or underbanked borrow to pay for small-dollar, short-term needs. Well-structured credit is essential to support a household's ability to save, build a considerable credit history, and to facilitate crucial investments that can provide a foundation for other wealth-building activities.

While excess credit is hardly desirable, consumers need access to appropriate forms and amounts of credit for their particular household needs.

Well-structured credit can support a household's ability to save.

It can do so directly by incorporating a savings feature into a debt product, or indirectly by providing a means to fund short-term spending without dipping into longer-term savings.

Building a credit history is a critical financial asset in its own right. Because credit scores are used by mortgage lenders, employers, insurers, landlords, and others, a positive credit history is crucial to long-term financial prosperity. Developing a sound credit history requires taking on and then paying down debt.

Credit can facilitate an investment or purchase that provides the foundation for other wealth-building activities. In many cases, credit can lead to financial prosperity by providing access to the tools and resources that lead to financial stability. Credit to purchase an automobile is an example.

There is a shortage of high-quality, small-dollar credit in the marketplace today. A gap in supply exists despite the fact that the last decade or more saw a dramatic and traumatic excess in availability and overuse of credit, which in many cases led to spiraling debt. Products with savings attached and financial education and management tools can position the consumer to do better with credit.

This paper, presented at the Harvard Joint Center on Housing Symposium, discusses the demand for short-term credit and examines credit products that hold potential to meet that demand. It explores the challenges to designing well-structured credit products that meet consumers needs and that generate a profit for the providers. Finally, it suggests business strategies and public policies options that can support the development of an efficient marketplace for high-quality, small-dollar credit.

30 million
Number of un and underbanked households in the U.S.
(FDIC, 2009)

33%
Percentage of un and underbanked U.S. households who borrow to pay for small-dollar, short-term needs

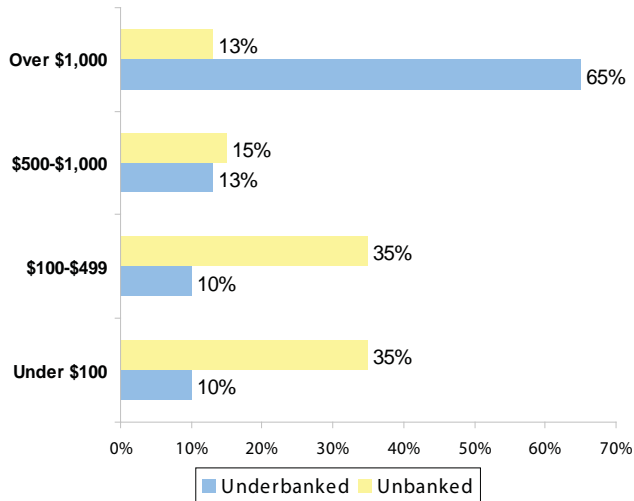
Almost 40%
Percentage of those borrowing to pay bills or to cover basic living expenses

16%
Percentage of underbanked individuals estimated to have obtained a loan from a payday lender within the last year
(FDIC, 2009)

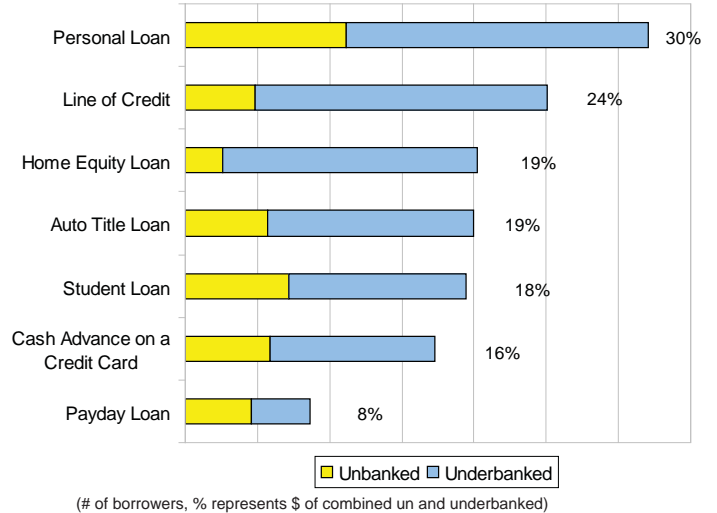
45%
Percentage of un and underbanked borrowers who would prefer to conduct financial transactions either with a Bank or Credit Union

Un and Underbanked Consumers' Borrowing Habits

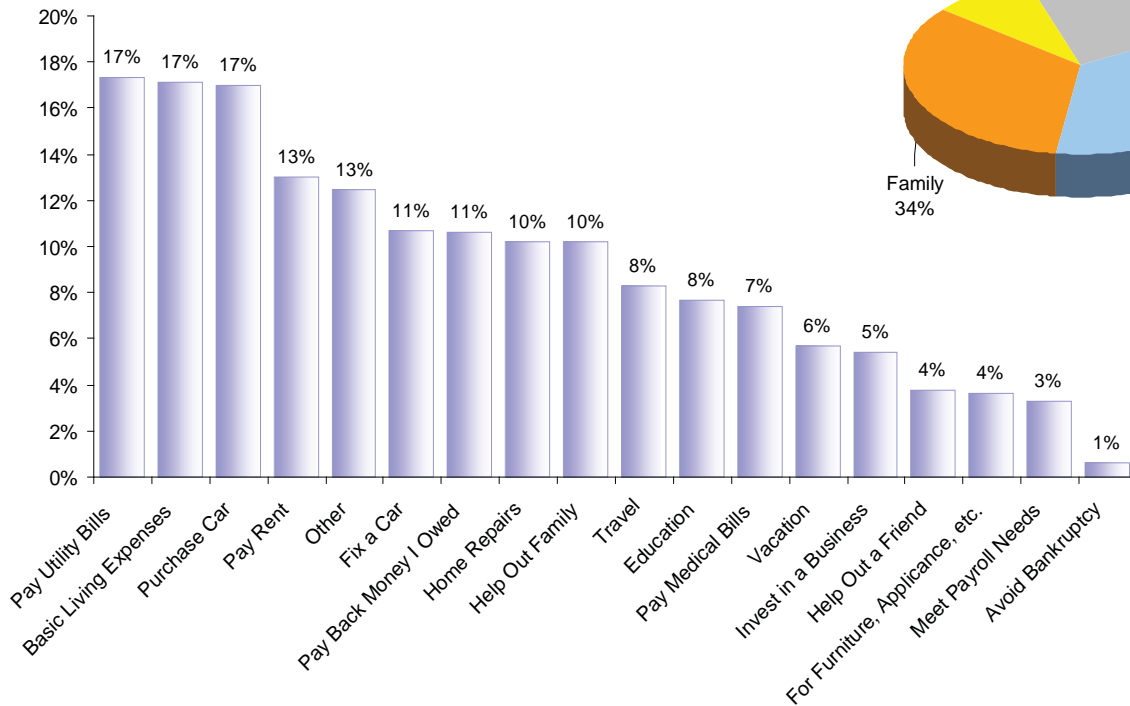
How much they borrow ...



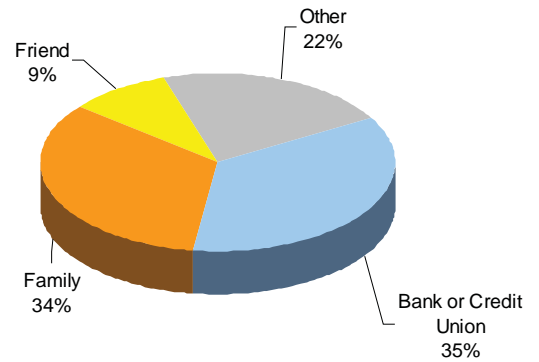
How they borrow ...



Why they borrow ...



Where they borrow ...



Models to Supply Small-Dollar, Short-Term Credit

Bank/Credit Union Small-Dollar Lending

Innovations/Advantages:

- Cross-subsidizes costs
- Generates a long-term customer relationship
- Loan data reported and accepted by major credit bureaus

Challenges:

- More time-intensive underwriting process
- Customer engagement can be time- and cost-intensive
- Demand varies by geographic location
- Higher overhead costs, including costs associated with maintaining a branch network

Workplace Lending

Innovations/Advantages:

- Reduces marketing and administrative costs
- Low to no defaults via automatic repayments through payroll debits
- Benefits employers as well as employees

Challenges:

- Obtaining capital for stability, growth, and expansion
- Risk of repayment may be prioritized above consumer necessities
- Underbanked may not be employed by employers offering workplace loans

Installment Lending

Innovations/Advantages:

- Larger loans and longer terms
- Fixed rates/equal repayments
- Loan data reported and accepted by major credit bureaus
- Direct interaction with consumer may facilitate responsible borrowing

Challenges

- Difficulty of securing capital for stability, growth, and expansion
- Costs of bricks-and-mortar model

Account Advance Products

Innovations/Advantages:

- Streamlines application, disbursement, and repayment process
- Eliminates underwriting with manageable impact on default losses

Challenges:

- Requires initial investment in technology: systems development to facilitate loan requests, disbursement, and repayment
- Capital requirements: high-risk nature of the loans leads to a high cost of funds or high reserve requirement
- High acceptance rate leads to high default rate
- Risk of repayment may be prioritized above consumer necessities

Small-Dollar Lending Challenges and Potential Solutions

Challenges

Potential Public Policy and Practice Solutions

Lack of Generally Accepted Criteria to Define High-Quality Credit Products

→ Establish criteria to assess credit products, which would include an analysis to ensure the loan(s) are:

- Structured to help borrowers meet short-term needs and improve longer-term financial stability and prosperity
- Transparent and fairly priced
- Affordable and support repayment, and
- Ensures repayment activity is reported to the credit bureaus

Insufficient Availability of Capital to Support Lending and the Growth of Small-Dollar Lenders

→ Form a Loan Loss Reserve Fund

- Policymakers should establish a loan loss reserve fund to increase the supply of well-structured small-dollar loans
- Businesses should form a loan fund enabling investors to pool investment dollars and diversify exposure

Clarify Bank Capital Requirements

- Regulators should provide greater clarity and consistency around the capital reserve requirements for depositories making small-dollar loans

High Operating Costs Inherent in the Business Models

→ Encourage Partnerships Among Lenders, Nonprofits, and Employers

- Develop business practices and public policies that leverage the trust, infrastructure, and physical presence of nonprofits and employers
- Seed workplace loan demonstrations at the government level
- Develop public policies encouraging workplace lending

Streamline Technology Systems

- Reduce the cost of application, underwriting, servicing, and customer support
- Customize technological solutions and work in collaboration

About CFSI

The Center for Financial Services Innovation is the nation's leading authority on financial services for underbanked consumers. Since 2004, its programs have focused on informing, connecting, and investing – gathering enhanced intelligence, brokering and supporting productive industry relationships, and fostering best-in-class products and strategies. A nonprofit affiliate of ShoreBank Corporation, CFSI works with leaders and innovators in the business, government, and nonprofit sectors to transform the financial services landscape. For more on CFSI, go to www.cfsinnovation.com.

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