Feature Article:

An Introduction to the FDIC's Small-Dollar Loan Pilot Program

On February 5, 2008, the FDIC selected 31 banks to participate in its Small-Dollar Loan Pilot Program.[1] The pilot is a two-year case study designed to illustrate how banks can profitably offer affordable small-dollar loans as an alternative to high-cost financial products, such as payday loans and fee-based overdraft protection. Participating banks provide quarterly information about their small-dollar loan programs, which will be analyzed to identify and report on the most effective features for creating profitable business models for such loans.

This article summarizes the key parameters of the pilot, the proposals that participating banks described in their applications, and the first quarter 2008 results. Overall, banks in the pilot originated more than 3,100 small-dollar loans, with a principal balance of about $3.7 million in the first quarter. Eight of the banks reported on existing small-dollar loan programs, while the remaining banks reported on new programs. It is difficult to draw conclusions on the basis of only one quarter of data for mostly new programs. However, an important initial observation is that small-dollar loans have provided pilot banks with opportunities for cross-selling other products, which creates significant potential for building profitable customer relationships.

Parameters of the Pilot

To be considered for the pilot, an insured institution had to meet the following requirements:

- A composite "1" or "2" rating on its most recent Safety and Soundness examination, and a Management rating of "1" or "2";
- Satisfactory policies and procedures in all areas, including lending, audits, aggregate risk, internal controls, liquidity, interest rate risk, compliance, and Bank Secrecy Act/Anti-Money Laundering;
- A composite "1" or "2" rating on its most recent Compliance examination;
- At least a "Satisfactory" rating on its most recent Community Reinvestment Act evaluation; and
- Not currently subject to a formal or informal enforcement action or the subject of an investigation or inquiry.

A key goal of the pilot is to observe and encourage participating institutions to experiment with providing safe, sound, affordable, and profitable small-dollar loans. Therefore, the FDIC provided only general guidelines for banks that sought to participate. It was anticipated that programs would be generally consistent with the FDIC's Small-Dollar Loan Guidelines, with room for some exceptions.[2] The following are some of the primary features described in the Guidelines:

- Loan amounts of up to $1,000
- Payment periods that extend beyond a single paycheck cycle
- Annual percentage rates (APRs) below 36 percent
- Low or no origination fees
- No prepayment penalties
- Streamlined underwriting
- Prompt loan application processing
- Automatic savings component
- Access to financial education

[1] More information regarding the FDIC Small-Dollar Loan Pilot Program can be found at http://www.fdic.gov/smalldollarloans.

[2] The FDIC's Small-Dollar Loan Guidelines, issued on June 19, 2007, can be found at http://www.fdic.gov/news/news/press/2007/pr07052a.html.

Small-Dollar Loan Program Proposals from Participating Banks

Banks that met the selection criteria submitted an application to the FDIC describing their existing or proposed small-dollar loan programs. The FDIC selected 31 banks, with assets ranging from $26 million to $10.4 billion, to be part of the pilot (see Table 1). The participating banks are headquartered in 17 states and have more than 560 branches located in 27 states. The banks have on average 18 branches, although the number of branches varies from 1 to 67.[3]

[3] Data are from first quarter 2008.

Eight of the 31 banks had small-dollar loan programs operating when they applied for the pilot, while 23 banks described new programs. Many of the banks—especially those with new programs—have already made changes based on lessons learned during the design and launch phases. However, it is useful to summarize their initial plans to track and report on the outcomes of practices as the pilot proceeds.

Loan Characteristics. At the time of application, 24 banks indicated that they would offer only closed-end credit, two indicated that they would offer both open- and closed-end credit, one indicated that it would offer only open-end credit, and four were unclear as to the type of credit they would offer. Banks in the pilot set initial maximum interest rates

Table 1

Small-Dollar Loan Pilot Program Participants Vary in Size

Bank	Location	Total Assets ($000s)	Number of Branches
Amarillo National Bank	Amarillo, TX	2,623,339	15
Armed Forces Bank	Fort Leavenworth, KS	803,840	51
Bank Commerce Stilwell	Stilwell, OK	77,098	3
Bank Five	Fall River, MA	671,445	13
BBVA Bancomer USA	Diamond Bar, CA	141,008	33
Benton State Bank	Benton, WI	45,833	3
Citizens Trust Bank	Atlanta, GA	354,311	10
Citizens Union Bank	Shelbyville, KY	579,178	20
Community Bank & Trust	Cornelia, GA	1,148,448	44
Community Bank of Marshall	Marshall, MO	84,815	6
Community Bank-Wheaton/Glen Ellyn	Glen Ellyn, IL	300,497	3
Cooperative Bank	Jacksonville, NC	958,700	24
First National-Fairfax	Fairfax, MN	26,010	1
First State Bank	Tonganoxie, KS	317,881	9
First United Bank	Crete, IL	495,480	5
Kentucky Bank	Paris, KY	633,263	16
Liberty Bank	New Orleans, LA	377,924	17
Liberty National	Paris, TX	246,857	3
Main Street Bank	Kingwood, TX	201,244	3
Mitchell Bank	Milwaukee, WI	81,555	11
National Bank of KC	Overland Park, KS	942,043	6
Newbridge Bank	Greensboro, NC	2,068,656	41
Oklahoma State Bank	Guthrie, OK	41,804	4
Pinnacle Bank Nebraska	Lincoln, NE	2,182,610	56
Red River Bank	Alexandria, LA	647,274	12
Riverside National Bank	Fort Pierce, FL	4,519,993	67
State Bank of Alcester	Alcester, SD	82,866	1
The Heritage Bank	Hinesville, GA	664,455	28
The Savings Bank	Wakefield, MA	389,335	9
White Rock Bank	Cannon Falls, MN	148,214	7
Wilmington Trust	Wilmington, DE	10,377,373	44

Note: Data are from first quarter 2008.
Source: FDIC

between 11 percent and 36 percent, with an average of 18 percent. Two-thirds of the banks planned to offer maximum interest rates in the 13 percent to 18 percent range (see Chart 1).

Fifteen banks reported that they would charge an application fee. The fees ranged from $18 to $61.50, with an average fee of $34. For banks providing APRs, the average for their small-dollar loans ranged from 14 percent to 27 percent.

Loan terms ranged from three biweekly installments (six weeks) to 36 monthly payments. As shown in Chart 2, maximum planned loan terms were fairly well distributed among banks offering 12, 24, and 36 monthly payments.

Underwriting and Program Features. At the time of application, most banks did not address the use of credit scores in underwriting, although four banks specified that minimum credit scores would be required and three indicated that there would be no minimum credit scores. Five banks indicated that they planned to underwrite small-dollar loans within 24 hours of application submission, while the other banks did not address turnaround times.

Most banks did not indicate whether deposit account relationships would be a prerequisite for consumers receiving small-dollar loans. However, nine banks indicated that they would require such a relationship. Of these banks, six indicated that direct deposit of a paycheck or another income stream would be mandatory. Moreover, four of these six banks (and two others) encouraged automatic debit for note payments.

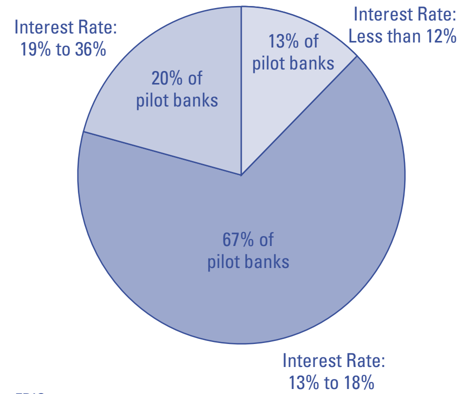
Seventeen banks did not specify a consumer education component in their applications, while 14 banks mentioned some sort of financial literacy component. Many applications described consumer education very generally, for example, mentioning that credit counseling would be made available as needed or indicating that financial literacy materials are available in the bank branch.

A few banks provided more explicit descriptions of financial education. One application indicated that three formal financial education classes would be required for customers with very low credit scores. Another bank, which receives referrals for its small-dollar loan program from a nonprofit organization, described a comprehensive financial literacy package featuring budget evaluation, case management, financial education, and a crisis-intervention program that is a prerequisite to a consumer being referred for a small-dollar loan. Another bank indicated that it would offer a $15 rebate of the application fee to small-dollar loan applicants who completed a formal financial literacy course.

Linked Savings Programs. In launching the pilot, the FDIC indicated a particular interest in programs with automatic savings features. The FDIC plans to determine whether savings products linked to small-dollar loans will reduce customer reliance on short-term,

Chart 1

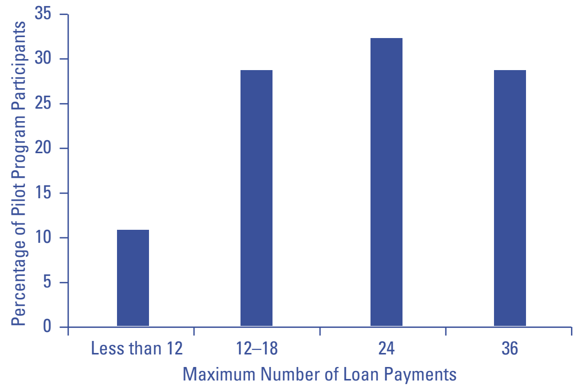
Eighty Percent of Small-Dollar Pilot Program Banks Offer Interest Rates of 18 Percent or Less



Source: FDIC

Chart 2

Most Small-Dollar Loan Pilot Program Participants Plan to Offer Loans with between 12 and 36 Installments



Source: FDIC

high-cost credit over time. Sixteen banks planned to have mandatory savings elements in their small-dollar loan programs, while another 4 encouraged savings and 11 indicated no plans for linked savings accounts.

All of the savings programs indicated that the savings accounts would partially collateralize the loans and specified limits on withdrawals, generally tied to the life of the loan. Six banks indicated that some portion of the amount borrowed, ranging from 5 percent to 25 percent, would be added to the principal amount of the loan and deposited into a savings account. One bank indicated that a flat $500 would be added to the principal of each loan and deposited into a savings account. Four banks said they would require periodic deposits to savings accounts by adding some amount—$10 or $15, or 25 percent of the payment—to each scheduled loan repayment.

Five banks indicated that they would make financial contributions to the savings accounts of borrowers as follows:

- An additional 10 percent in principal will be added to the loan and deposited into a savings account. If the loan is repaid as agreed and the customer is able to match the original deposit into savings, the bank will refund application fees.
- At the time of the loan, the bank will open a savings account for the customer and deposit $1. If the loan performs as agreed, the bank will match customer deposits into the account up to $100.
- At the time of the loan, the bank will add $15 to the principal of the loan and deposit it in a savings account. If the loan performs as agreed, the bank will add 10 percent of the balance of the savings account to the customer's account.
- At the time of the loan, customers will have the option of opening a savings account with as little as $5. The bank will match the opening deposit up to $25.
- Customers will be encouraged to open a passbook savings account with as little as $1 and a waiver of all service charges. The bank will match the first $10 in deposits in each account.

Marketing and Advertising. Nine banks indicated that small-dollar loans would be offered only to their existing customers, while the remainder were undecided at the time of application or indicated that the program would be open to both existing and new customers.

Sixteen banks specified target markets for their small-dollar loan products, with some targeting multiple markets:

- Ten specified low- and moderate-income households.
- Four specified military personnel.
- Three specified college students.
- Two specified the Latino market.
- One specified the Native American market.

One bank indicated that it planned to offer seasonal small-dollar loans around holidays and during tax season.

The banks outlined a number of diverse advertising strategies in their applications for the pilot. They mentioned 66 different but related approaches, the most common of which were media advertising (11 banks) and point-of-sale displays (10 banks) (see Table 2).

Summary of First Quarter 2008 Results

First quarter 2008 results were due May 15, 2008. Of the 31 banks in the pilot, 29 submitted reports.[4] Of those banks, 8 reported on programs that existed before the pilot, and 21 reported on newly developed programs. Four of the banks with new programs indicated that they did not make any small-dollar loans during the quarter, as they were finalizing aspects of their programs. The 25 banks that originated small-dollar loans during the quarter all reported that they made only closed-end loans.

Banks were asked to provide separate data points for loans of up to $1,000 and more than $1,000. This threshold is consistent with the Guidelines and was chosen for the pilot to determine whether the $1,000 level can be used as a "bright line" for a replicable small-dollar loan template (see Table 3). In addition, five of the banks with existing programs

[4] The two banks that did not submit reports indicated that they did not originate small-dollar loans in first quarter 2008.

Table 2

Marketing Category	Marketing Approach	Number of Banks Using Approach	Percentage of Approach Usage[a]	Percentage of Banks Using Approach (31 Banks)	Percentage of Total Usage for Category[b]
Traditional bank marketing	Providing brochures	1	1.5	3.2	37.9
	Direct mailing	4	6.1	12.9	
	Statement stuffers	4	6.1	12.9	
	Financial literacy programs	6	9.1	19.4	
	Point of sale displays	10	15.2	32.3	
Staff or community-based marketing	Outbound calls	2	3.0	6.5	33.3
	Staff incentives	1	1.5	3.2	
	Market to current customers	4	6.1	12.9	
	Word of mouth	4	6.1	12.9	
	Referrals from nonprofits	5	7.6	16.1	
	Via social service organizations	4	6.1	12.9	
	Via churches	2	3.0	6.5	
Media marketing	Media announcements	3	4.6	9.7	21.2
	Media advertising	11	16.7	35.5	
Internet marketing	Bank website advertising	4	6.1	12.9	7.6
	Internet advertising	1	1.5	3.2	
	TOTALS:	66	100.0	N/A	100.0

Pilot Program Banks Have Diverse Marketing Strategies

Source: FDIC

[a] Sixty-six distinct, but often related, approaches were noted in the bank applications. This column shows the distribution of the use of the 66 approaches.

[b] The 66 approaches were organized into four marketing categories. This column shows the distribution of the use of the four categories.

had disproportionately large programs compared with those of the other banks; therefore, results for these banks are isolated from the rest of the group in Table 3 to prevent skewing the loan volume. However, with respect to basic loan characteristics—such as interest rates, fees, and repayment terms—there is little difference between banks that made a few loans and those that originated a large volume of loans. Therefore, there is no distinction between large and small programs for the small-dollar loan term data in Table 4.

As shown in Table 3, 20 banks originated 1,523 loans of $1,000 or less with combined principal of about $1 million. Four banks originated almost 1,400 of these loans, with one particularly active bank reporting 966 loans of $1,000 or less. Excluding these large originators, the 16 banks that made small-dollar loans up to $1,000 originated eight loans on average.

For loans above $1,000, 15 banks originated 1,617 loans with combined principal of about $2.7 million. Five banks originated more than 1,500 of these loans, with one bank reporting 623 loans above $1,000. Excluding these large originators, the ten banks that made small-dollar loans above $1,000 originated eight loans on average.

Table 4 summarizes the basic characteristics of small-dollar loans made in first quarter 2008. For banks that made loans of $1,000 or less, the average loan size was $678, the average loan term was ten months, and the average interest rate was 15.1 percent. Seven banks that originated loans of $1,000 or less reported APRs averaging 23.8 percent.

For banks that made loans above $1,000, the average loan size was $1,695, although two banks in this group reported making average loans greater than $3,000.[5] The average loan term for loans in excess of $1,000 was 17 months, and the average interest rate was 15.5

[5] In this initial reporting period, to encourage innovation, there was no limit on the loan amount that could be included in the pilot. An unintended consequence of not having an upper limit was that a few banks reported several larger loans that may have skewed the average. As the result of a discussion with participating banks about what constitutes a small-dollar loan, a reporting limit of $2,500 will be imposed for future data submissions.

Table 3

Small-Dollar Loan Pilot Program 1Q08: Summary of Loan Number and Volume Data					
	Number of Banks Reporting	Total	Average	Minimum	Maximum
Loans Up to $1,000					
All Banks					
# of Notes	20	1,523	53	1	966
Note Volume	14	$1,013,118	$72,366	$401	$641,050
Banks Originating Fewer Than 50 Loans					
# of Notes	16	132	8	1	29
Note Volume	10	$71,147	$7,115	$401	$21,710
Banks Originating More Than 50 Loans					
# of Notes	4	1,391	348	55	966
Note Volume	4	$941,971	$235,493	$24,450	$641,050
Loans Over $1,000					
All Banks					
# of Notes	15	1,617	108	1	623
Note Volume	12	$2,696,996	$224,750	$1,500	$1,207,145
Banks Originating Fewer Than 50 Loans					
# of Notes	10	75	8	1	28
Note Volume	7	$124,109	$17,730	$1,500	$78,420
Banks Originating More Than 50 Loans					
# of Notes	5	1,542	308	57	623
Note Volume	5	$2,572,887	$514,577	$121,544	$1,207,145

Source: FDIC

Table 4

Small-Dollar Loan Pilot Program 1Q08: Summary of Loan Characteristics				
	Number of Banks Reporting	Average	Minimum	Maximum
Loans Up to $1,000				
Loan Amount	14	$678	$100	$1,000
Term (months)	19	10	3	27
Interest Rate (percent)	19	15.05	5.25	33.00
Non-zero Fees (dollars)	4	$40	$12	$65
APR	7	23.80	11.00	34.00
Loans Over $1,000				
Loan Amount	12	$1,695	$1,202	$3,750
Term (months)	14	17	5	36
Interest Rate (percent)	15	15.53	9.21	31.41
Non-zero Fees (dollars)	4	$59	$25	$134
APR	4	16.48	11.19	22.88

Source: FDIC

Small-Dollar Loans Open the Door to Profitable Relationships

Armed Forces Bank: Using Small-Dollar Loans to Retain Customers

Armed Forces Bank in Fort Leavenworth, Kansas, with more than $800 million in total assets and 51 branches, has been originating small-dollar loans for about four years. The program has about $4.5 million in loans outstanding (about $1.8 million was booked in first quarter 2008) and is targeted almost exclusively to military personnel. Armed Forces Bank generally offers loans from $250 to $2,000. All loans are closed-end transactions for up to 24 months. The interest rate is 18 percent, and there are no fees. The borrower must open an account with the bank and maintain direct deposit. Loan payments are automatically debited from the borrower's account.

Armed Forces Bank views its small-dollar loan as a retention product that helps customers who are experiencing problems regain their financial integrity and allows them to remain in a banking relationship. Armed Forces Bank reports that it generally breaks even on this program and that relationships with small-dollar customers are just as profitable as those with customers who use more traditional products and services. In addition to obtaining the use of funds from the mandatory direct deposit, the bank has been successful in migrating small-dollar loan customers to other products. In first quarter 2008, 64 small-dollar loan customers who paid as agreed migrated into traditional loan products.

Pinnacle Bank: Using Small-Dollar Loans to Create New Relationships

Pinnacle Bank, headquartered in Lincoln, Nebraska, is a $2.2 billion bank with 56 branches. Pinnacle Bank's small-dollar loan program is new; the first loans under the program were originated during first quarter 2008. The program was initially piloted in two branches in Lincoln and Omaha, and was targeted to the Latino market. Pinnacle originated 19 loans under its small-dollar loan program through the first quarter. All loans are closed-end, with terms ranging from seven to ten months, and interest rates are about 10 percent. Fees of up to $50 may be assessed, but beginning in third quarter 2008, half of the fee will be rebated if the customer opens a savings account.

While it is too early to assess the overall profitability of the program, Pinnacle Bank has noted that the program has not negatively affected bank profitability. Pinnacle Bank views the small-dollar loan as a way of introducing new customers to the bank and noted that 18 of its 19 small-dollar loan customers have expanded their relationship with the bank by migrating to other products. Most have added checking accounts; 14 have debit cards; 5 have savings accounts; 1 has a certificate of deposit; and 1 has opened an Individual Retirement Account. Pinnacle Bank has been pleased with the response to the new program so far. Beginning in second quarter 2008, the program was expanded to all branches in Lincoln and Omaha, and Pinnacle will soon begin a marketing campaign with direct mail and newspaper advertisements. The marketing plan will specifically address the encouraged savings component, offering borrowers a coupon for $25 toward new saving. Advertising will also directly position Pinnacle's small-dollar loan as an alternative to payday lending.

percent. Four banks that originated loans in excess of $1,000 reported APRs that averaged about 16.5 percent.

Other Program Statistics. Since most of the small-dollar loan programs are new and reporting has just begun, only five banks reported delinquencies for loans made in the first quarter, ranging from 1 to 19 loans per bank.

Of the 29 banks that reported first quarter results, linked savings are mandatory for 13 programs, strongly encouraged for 8 programs, and not required for 8 programs. Thirteen banks reported that a total of 46 linked savings accounts were opened. Ten banks reported an approximate aggregate balance of $21,300 in linked savings accounts.

Three banks noted that they believed small-dollar loan customers were using fewer high-cost debt products, although these observances were mostly anecdotal.

Few banks provided profitability data for their programs, primarily because most programs are new and have a relatively low volume of loans. However, three banks indicated that they broke even on the small-dollar loan product, while two indicated that they did not. Including deposits and other accounts, five banks reported that the overall relationship with small-dollar loan customers was profitable, while two reported that it was not.

The relationship-building aspect of the small-dollar loan product could prove to be important in determining the feasibility and profitability for banks in the pilot. More than half (13) of the 25 banks that reported first quarter results indicated that customers have already migrated to other bank products from the small-dollar loan product, while only 2 banks reported no migration. Deposit accounts are the predominant products that pilot banks have opened for small-dollar customers, although other, more sophisticated products also have been provided. One bank that had an existing program indicated that many small-dollar loan customers are approved for auto loans after their initial small-dollar loan is paid and that "auto loans appear to be the next step in establishing a lending relationship with small-dollar loan customers."

Two case studies presented in the text box highlight the profit potential for cross-selling to small-dollar loan customers.[6] Armed Forces Bank has the largest and oldest program in the pilot; it reports that while the small-dollar program breaks even, the overall customer relationship is as profitable as a traditional relationship. Pinnacle Bank created a new small-dollar loan program and is not yet able to assess its profitability. However, it reports strong migration to other bank products (18 of 19 borrowers) and views the small-dollar loan as an important draw for new customers.

[6] Banks listed in this article are for illustration only. The FDIC does not endorse any bank or product.

Conclusion

Although the Small-Dollar Loan Pilot Program is still in its initial stages, participating banks are already demonstrating innovative strategies in areas such as advertising and linked savings that may prove to be replicable for other banks. Banks in the pilot are well within the 36 percent maximum APR established in the FDIC's Small-Dollar Loan Guidelines, and five banks thus far have reported using the small-dollar product as a cornerstone for profitable relationships. These early results provide some indication that banks can profitably provide affordable alternatives to high-cost, short-term credit. The FDIC will continue to explore profitability and other noteworthy features of participating bank programs as the pilot progresses.

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