Developing a Research Agenda on Small-Dollar Credit and Financial Empowerment
March 4, 2010
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Convening Overview

Millions of American households, especially those in the bottom half of the income distribution, use nonbank credit products, such as payday loans, car title loans, and refund anticipation loans, to meet short-term needs. This credit, while small in initial denomination, can add up to significant debt burdens for those who can least afford it.

The U.S. Department of the Treasury gathered 50 foundation representatives and researchers from academia, government, the nonprofit sector, and industry to participate in the convening *Developing a Research Agenda on Small-Dollar Credit and Financial Empowerment*, held on Thursday, March 4, 2010. Participants shared insights as to what research questions need to be answered so that policy can be made, especially at the federal level, to ensure that credit meets consumer need, is provided fairly and clearly, is viable for credit providers, and is available in appropriate amounts, forms, prices, and venues.

The goal of the convening was to identify what research is underway, planned, and needed to inform policymaking that can address the challenges related to meeting the small-dollar credit needs of underserved populations, notably low- and moderate-income individuals.

The one-day event included discussions on both the demand for and supply of small-dollar credit. The demand-side discussion began with an overview of current findings. Participants were then asked to contribute insights, examples of current research underway, and future research questions on the topics of who uses small-dollar credit products, why people use them, and whether small-dollar credit use is optimal or rational. During the supply-side discussion, participants were asked to do the same on the topics of who supplies small-dollar credit, what affects supply, and what the emerging trends are among suppliers. The day concluded with a discussion of policy and administrative implications and future directions for research.

This document briefly summarizes the convening, with a focus on what participants cited as important future research questions.

Summary—Demand Side:
Why Do Consumers Use Small-Dollar Credit Products?

Moderator: Signe-Mary McKernan, Senior Research Associate, The Urban Institute

The demand-side discussion began with a summary of what is known from the literature on who uses small-dollar credit products.

According to the FINRA Investor Education Foundation *2009 National Survey of Financial Capability in the United States*, of American adults:

- In the past 5 years, percentage that have used the following products:
  - 8% pawnshop, 8% RAL, 7% auto-title, 5% payday, 5% rent-to-own (RTO).
  - 23% have used at least 1 of these methods.
  - The majority (70%) of users used 1 product
    - 30% had used 2 or more
    - 9% had used 3 or more
  - These subgroups are more likely to use them (with the exception of auto-title loans):
    - Unbanked (44% vs. 20%);
    - Don't have a credit card (34% vs. 19%);
    - Young (age 18-29);
    - Low-income (<$25,000);
    - Without high school education; and
    - African-Americans and Hispanics.
- Use varies by household income:
  - Pawnshops, RALs, and RTO stores are used most by households with incomes < $25,000.
  - Payday loans are used equally by households with income <$25,000 and income $25,000-$75,000.
  - Auto-title loans are used most by households with incomes >$75,000.

According to *CFSI 2008 Underbanked Consumer Study*,

- Two distinct groups of borrowers among unbanked and underbanked households:
  - Larger amount once per year
    - 83% borrowed over $1,000,
    - To purchase a car or truck.
  - Smaller amounts more frequently
    - $100 - $1,000 two to four times per year,
    - To pay for utilities (32%), home repairs (31%), basic living expenses (22%), repay debt (21%), or medical bills (17%).

Convening participants commented that defining subpopulations as "unbanked" suggests that bank products are preferred solutions despite little research having demonstrated their advantages over nonbank products. One participant noted the parallels between small-dollar nonbank financial products and the bank credit cards used by more privileged populations. Borrowers could be further broken down into categories of occasional users, those with chronic debt, and those who use these products when an emergency arises.

When considering different types of small-dollar loan products, consumers' primary selection criteria include access, convenience, marketing, and transparency. Geographic proximity to a bank does not guarantee access. Banks may not offer the product needed, provide immediate approval or access to the money, or be open at convenient hours. Additionally, nonbank providers tend to offer a welcoming atmosphere and personal interactions with their employees (who often live in borrower's neighborhoods), attracting borrowers who feel uncomfortable in a bank setting. Some convening participants thought that nonbank small-dollar credit borrowers were making rational choices and that greater transparency in alternative provider costs and prices (relative to bank fees) was an important part of that choice. The group identified the following future research questions on the demand side.

Future Research Questions: Demand Side

Relationship between various products

- Why do people choose different products and which products are substitutes? What are the interactions between different products?
- What is the relationship between direct deposit and credit products?
- What are the implications of product type and use for social and consumer outcomes?

Savings and asset building

- What is the relationship between credit and savings? Are people who use small-dollar credit products less likely to have and accumulate savings?
- How does small-dollar credit product use affect asset and wealth building?

Education, advertising, and consumer choices

- Does financial literacy improve credit product use outcomes? To what extent does the timing and type of education matter?
- How do borrowers make decisions on small-dollar credit and assess trade-offs?
- What is the role of advertising, persuasion, and marketing in small-dollar credit use?

Access

- What occurs when one or more sources of credit becomes unavailable?
- What role does guaranteed loan approval play in small-dollar credit choice and use?
- Is it better for consumers to have no credit score or a low credit score?
- Do banks and other depository institutions want small-dollar customers?
- To what degree does restricted access (perceived or otherwise) to credit and the cost of credit reflect actual risk?
- What are the implications of local regulations such as zoning for access to credit products?
- Does availability of small-dollar credit affect discretionary spending? For example, are people who would otherwise not consider it taking out payday loans because they're available?

Understanding consumers

- ♦ To what extent does small-dollar credit lead to financial distress? How does this vary by product? Does it differ for collateralized versus noncollateralized products?
- ♦ What happens with small-dollar credit use over time?
- ♦ What do we know about people who have chronic debt?
- ♦ Who relies on informal lending practices (e.g., friends and family), in what ways (e.g., amounts, frequency, terms), and why? How does this relate to alternative financial sector use?
- ♦ What is the relationship between a low-income household's balance sheet and its relationships with its family and community?
- ♦ What are informative measures of individuals' overall financial health?
- ♦ To what extent are small-dollar credit products used to fill income gaps?
- ♦ How do changes in the macro economy, income inequality, and immigration affect the demand for small-dollar credit? How do these affect outcomes?
- ♦ What can we learn from other countries about the demand for small-dollar credit products?

Summary—Supply Side:
What Are the Small-Dollar Credit Options for Underserved Borrowers?

Moderator: Melissa Koide, Policy Director, Center for Financial Services Innovation

The moderator provided an overview of different types of small-dollar credit, including:

- Payday Lenders, Pawnshops, RTO, Auto-title Lenders, Refund Anticipation Lenders, Depositories, and Installment Lenders
- Provider Examples:
  - Payday lending industry
  - FDIC Small-Dollar Loan Program

Koide also identified emerging developments and products in this area, including:

- Use of non-traditional data to underwrite loans
- Depositories offering short-term, small-dollar loans as salary or account advance products
- Small-dollar loans attached to prepaid cards
- Workplace lending, whereby loans or lines of credit are initiated in the workplace
  - Payments through automatic payroll deductions
- Credit products in combination with savings products and financial education
- Loan loss reserves to bring scale to small-dollar lending

Leslie Parrish from the Center for Responsible Lending provided a brief overview of the structure of payday loans. Rae-Ann Miller from the FDIC provided the following findings from the FDIC's pilot on bank-based small dollar loans.

- In February 2008, 31 banks were selected to participate in the Small-Dollar Loan (SDL) Pilot Program.
- The two-year case study investigates how banks can profitably offer small-dollar as an alternative to high cost financial products.

- Data are collected quarterly from 1Q08 through 4Q09.

The pilot provided the following guidelines:

- Loan amounts up to $1,000
- Payment periods that extend beyond a single paycheck
- 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

Through the third quarter of 2009:

- 23 banks provided a total of 2,229 loans up to $1000, with an average loan amount of $729. The average loan term was 12 months and the average interest rate 13.88%.
- 13 banks provided loans 2,178 of $1,000 to $2,500 with an average loan amount of $1,719. The average term was 16 months and the average interest rate was 13.74%.

Miller noted the following factors were important the pilot feasibility:

- Senior management and Board of Director support
- Strong commitment to community and community partnerships
- Engaged champion as program manager, preferably with lending and/or policy-making authority
- Location in low- and moderate-income communities and rural communities

Miller identified the following potential strategies to scale availability of small-dollar credit by banks:

- Amplify the facts about existing models
- Embrace new technologies and delivery channels
- Encourage partnerships
- Create guarantees
- Streamline regulatory issues

The diverse group of experts pointed to profitability, regulation, and market focus as key factors affecting the supply of small-dollar loan products. It is not clear whether small-dollar credit providers are profitable with APRs below 36 percent. The transactions costs are similar for small and large loans, yet small loans earn less revenue. Small-dollar credit providers often rely on an individualized, person-to-person model, which can be costly to deliver but are thought to drive lower default rates. Despite these efforts, small-dollar loan providers suggest that relatively high default rates hamper their profitability, resulting in lower earnings than what is perceived by the public. Qualitative research suggests that the most important determinant of whether individuals repay their debts is whether they feel product charges are legitimate. Having a person-to-person relationship with the credit provider is also important.

Participants commented that banks have less regulatory flexibility than nonbank providers and consequently cannot offer the same products at the same prices. Participants also noted that small-dollar loan providers re-label products and maneuver in other ways to avoid state regulation. On the topic of market focus, it was noted that 79 percent of banks are aware of the unbanked population in their market, yet only 16 percent of banks serve this population. Many banks see these consumers as “subprime,” and literature shows that the major reason people turn to nonbank products is a poor credit profile.

Some providers act as one-stop shops and meet the multiple needs of their consumers. For example, some pawnshops also provide payday loans or act as tax preparers.

Participants at the convening also discussed emerging small-dollar loan models. Among those discussed were employer-based models, lines of credit attached to prepaid cards, and government-based pilots (such as the FDIC Small Dollar Loan Pilot). Discussion of these new models centered on (i) whether consumers could be moved to a mainstream product after a given time period; (ii) their use of alternative credit histories for underwriting purposes; (iii) their ability to achieve low loss rates by developing a comprehensive financial picture of the consumer; and (iv) their degree of transparency with the consumer.

Future Research Questions: Supply Side

Available products and costs

- What is the range of small-dollar credit products being offered, where are they being offered, and at what price?
- What is the profit and loss of suppliers across different products? Is there a place in which this information can be disclosed safely?
- How can affordable small-dollar credit products achieve greater scale?
- What is the impact of securitization on credit availability and outcomes?
- What can we learn from other countries about the supply of small-dollar credit products?

Understanding the market

- What cross-subsidization is taking place across products?
- What cross-subsidization is taking place across borrowers?
- If shifts in demand and supply pull in more high-risk borrowers, who will pay the higher prices?
- Do banks and other depository institutions want small-dollar credit customers?
- What can we learn about micro-populations, such as immigrants, students, and those in the military?
- What can we learn from a large-scale demonstration and evaluation of an employer-based model?
- What is the optimal level of supply?
- What are the cost drivers that determine market prices? What are the different components in the lending supply chain?

- How can direct-deposit research inform small-dollar lending?
- What defines "responsible lending"? What constitutes an "affordable loan"?

Provider practices

- What is the role of technology in increasing the supply of small-dollar credit?
- Should banks be incentivized to provide short-term, small-dollar products and services? If so, how? What is the regulators' role?
- What alternative underwriting practices are in use and how accurate are they relative to traditional underwriting for low-income populations over time?
- What are the costs and benefits of tying small-dollar credit with savings and financial literacy?

Summary—Policy and Administrative Implications

Moderator: Michelle Greene, Deputy Assistant Secretary for Financial Education and Financial Access, U.S. Department of the Treasury

The moderator provided an overview of the scope of state regulation of small-dollar credit.

- The majority of states provide some form of regulation of non-bank, small-dollar credit products.
- The four main categories of regulation are (1) disclosures, (2) price caps, (3) prohibitions, and (4) contract requirements.
- Disclosures and price caps have been placed on different components of price, including restrictions on total dollar costs, interest rates, and annual percentage rates.
- 46 states have a price cap on at least one of the five products.
- A number of states explicitly prohibit these small-dollar credit products. Twenty seven states prohibit auto title loans, and twelve states prohibit payday loans.
- Payday lenders also face restrictions on loan periods and maximum loan amounts.
- The majority of states impose an interest rate cap on pawn shops and payday lenders.
- In contrast, less than half the states impose disclosure or price caps on Rent-to-Own agreements.

Auto Title Restrictions	
Auto title loans prohibited	27 states[1]
APR cap	13 states[2]
Pawnshop Restrictions	
Monthly interest rate cap	40 states
Return requirement	10 states
Payday Loan Restrictions	
Payday loan prohibited	13 states
APR cap	33 states
Maximum loan amount	33 states
Minimum or maximum period	35 states
Fee disclosure requirement	34 states
Refund Anticipation Loan Restrictions	
APR cap	3 states
Disclosure requirements	17 states
Right to rescind	2 states
Rent-to-Own Restrictions	
Total cost or APR cap	11 states
Total cost label disclosures	16 states
Reinstatement rights[3]	46 states

Note: Some restrictions are aggregated for the purposes of this table. For example, at least three types of disclosures may be required by rent-to-own regulations, but they are combined for the purposes of this summary table. APR, fee, and price caps are also combined.
1. Texas prohibits auto title loans, but lenders circumvent restrictions with unregulated credit service organizations.
2. South Carolina has an APR cap, but it only applies to small auto title loans and thus does not cover many loans.
3. Requires stores to reinstate the terms of an agreement if a delinquent borrower meets certain requirements.

Turning to policy and administrative implications, the group of experts commented on the role of disclosure policies and financial education, as well as the possible role of government in promoting responsible lending. Based on literature and discussion, many in the group agreed that APR disclosures are not helpful to consumers in the short-term, small-dollar credit area. It was also noted that consumers are capable of rational decision-making if they know the price at the time a decision is being made. Regulators could help by making a standard set of information available to consumers. It was suggested that disclosures be developed through in-depth qualitative work and testing. One participant noted that disclosures could have limited impact even if they are well developed because they are costly to enforce.

Experts noted that the timing and type of financial education matter. Financial education does not have to come from a seminar. Creating opportunities and incentives to provide “just in time” information (e.g., not when looking at a credit card statement or rent-to-own agreement, but when the person is deciding on the actual transaction) would be very helpful. Literature has shown that financial education tied to lending activities may decrease the likelihood of a consumer taking part in an activity that is financially detrimental and may help steer consumers toward good financial outcomes. Despite the low credit score of the majority of people using small-dollar credit products, few resources are available to help people raise their credit scores. Many counselors are paid for by lenders and do not provide unbiased counseling. The timing of education is important for better outcomes.

A key role discussed for policy and administration was to begin providing a simple statement of the government agenda and to define and set a standard for responsible lending. These would provide an important foundation for researchers, providers, and innovators. Such a standard might include defining the ability of a person to pay. Federal licensing could be used as a carrot for providers defined by responsible lending. Future research questions identified in the policy area follow.

Future Research Questions: Policy

Informing policy

- How can policies and regulations impact availability and use of (better) small-dollar credit?
- What are the upsides and downsides of policy and regulatory actions? How do you frame policy to ensure that people are getting products suitable for their needs?
- What is the difference between the expected use and actual use of credit products? Can policy influence this disparity?
- How would taxpayers fare if the allocation of refunds were distributed over the year?
- What are the varieties of products individuals use to build up more assets? What are the connections between debt and asset building?
- Why do people need and demand loan products and for what timeframe? What are their expectations in the beginning and what was the outcome?

Potential policy actions

- How can government incentivize savings among low- and moderate-income populations so they can avoid high-priced small-dollar credit products?
- How can policy take advantage of technological advancements, such as electronic benefit transfer and text messaging, to affect financial behavior?
- What should be presented in disclosures, how should it be presented, and when? How should disclosures differ across products?
- Do disclosures reduce borrowing or move borrowers to a different source of credit? Is there a role for the government to provide short-term, small-dollar credit to vulnerable populations?

Monitoring and enforcement

- What data-reporting requirements should the government require from small-dollar lenders?
- What enforcement is occurring at the federal and local level; what types and levels of enforcement are most effective?

Summary—Future Directions for Research

Moderator: Louisa Quittman, Director of Community Programs for Financial Education and Financial Access, U.S. Department of the Treasury

Participants suggested future research methods and data and proposed that both government and foundations could support useful research. These included mixed methods research (quantitative with qualitative), demonstrations, and randomized experiments. The need for questions on small-dollar credit use (as well as assets and debts) in longitudinal surveys with large samples was highlighted by many. The need for transaction data, in addition to survey data, was also highlighted. Imbedding questions in lender applications was suggested as an additional data-collection tool.

Possible data sources for future research include the new FINRA data, transaction data from lenders, the FDIC CPS supplement on the unbanked and underbanked, financial diaries, and additional qualitative interview data. Many agreed that policy and administration could play a key role in supporting the expansion of access to research resources. Large data sets like the SIPP could play a key role in capturing financial health and behavior over time of households and would be even more useful if the panels were longer.

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