DATE: May 30, 2007

MEMORANDUM TO: Board of Directors

FROM: Michael H. Krimminger
Special Advisor for Policy

Sandra L. Thompson
Director
Division of Supervision and Consumer Protection

SUBJECT: FDIC Pilot Project for Affordable Small- Dollar Loans

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Recommendation: Staff recommends approval by the Board of Directors of a two-year pilot project to evaluate effective business models used by banks to offer small-dollar loans to consumers. The pilot project, to be known as the Affordable and Responsible Consumer Credit or ARC initiative, is designed to assist bankers by identifying and disseminating information on replicable business models for affordable small-dollar loans. Participating banks and thrifts will provide specified information about their small-dollar loan programs, which will be evaluated to identify the most effective features. The resulting "best practices" then will provide a resource for other insured institutions. While the number of participating institutions will depend on proposals from interested institutions, it is not expected to exceed forty insured institutions.

This proposal was presented to the Chairman's Advisory Committee on Economic Inclusion at its March 28, 2007 meeting. After discussion, the Committee recommended that staff seek FDIC Board approval for implementation.

Key Features of the Pilot:

- The selection of participants will be based on information describing their small-dollar loan programs from interested insured institutions. After verifying that the institutions are well-managed, well-capitalized, and not subject to enforcement or similar actions, a selection panel from the Division of Insurance and Research, Division of Supervision and Consumer Protection and the Legal Division will evaluate program information to identify those programs that combine key features drawn from the FDIC's Small-Dollar Loan Guidelines. Interest will be solicited from a wide spectrum of insured institutions. The banking trade associations are supporting this effort by soliciting interest among their member institutions that offer or are developing small-dollar loan programs.[1]
- Participating institutions supervised by the FDIC would warrant favorable

[1] The American Bankers Association, Consumer Bankers Association, America's Community Bankers and the Independent Community Bankers of America, Financial Services Roundtable (banking trade groups).

consideration under the Community Reinvestment Act (CRA) for providing credit responsive to the needs of many communities.[2] Where small-dollar loan products are combined with a low-cost savings account, institutions may also qualify for favorable consideration for providing community development services.[3] We anticipate that other institutions likely will be entitled to similar favorable consideration after review by their primary federal regulator.

- The FDIC will gather information about the participating institutions' small-dollar programs as part of its normal examination process and through periodic information collection via FDIC*connect* consistent with Office of Management and Budget (OMB) approval under the Paperwork Reduction Act (in process).
- The FDIC is particularly interested in small-dollar lending programs that include a savings component for borrowers.
- The key to this project is to observe the participating institutions' innovation and experimentation with providing safe and sound affordable and profitable small-dollar loans, consistent with the final FDIC Small-Dollar Loan Guidelines. By encouraging innovation, the FDIC hopes to use case studies to identify and widely disseminate information about the most effective strategies for bankers to offer affordable small-dollar loan programs.

Background

This project is designed to demonstrate the role that affordable small-dollar loans can play in replacing high-cost financial products as part of a bank's business plan to reach out to underserved communities and to develop new customers for mainstream banking services. Not only will a successful small-dollar loan program achieve positive outcomes for banks, but it will help integrate underserved consumers into the financial mainstream, encourage wealth-developing through savings, and reduce consumers' reliance on high-cost, non-bank service providers.

Background on Payday Lending: The payday lending industry now generates more than $28 billion in loans per year.[4] Payday loans are small value, very short-term loans typically extended to consumers with proof of employment and a checking account. Security to the lender is provided by a check or debit authorization post-dated to the borrower's next payday. Loans offered through payday loan stores typically have two-week terms, an average balance of $250-$300, and associated fees of around $15-$20 per $100 balance. This structure results in Annual Percentage Rates (APRs) often in excess of 390 percent. Borrowers make an appointment to return to the payday store on their payday to repay the loan in full or to roll over the loan (or a portion of it) which results in

[2] See Interagency Q&A's for CRA, 66 Fed. Reg. 36619, 36631. Sec. 345.22(a)-1 (July 12, 2001), http://www.fdic.gov/news/news/financial/2001/fil0164.html
[3] Id. at Interagency Q&A §345.12j-1
[4] King, Uriah, Leslie Parrish and Ozlem Tanik, "Center for Responsible Lending study: Financial Quicksand: Payday lending sinks borrowers in debt" (November 30, 2006)

the payment of another round of fees. If the customer fails to appear, the payday lender can deposit the check or undertake other collection efforts.[5]

A major perceived advantage of payday loans to the consumer is the immediate availability of funds and the relative anonymity of the borrower. The application process is streamlined and credit criteria minimal – often consisting of only the proof of employment and a checking account. Payday loan users cite both the immediacy of the funds provided along with the desire to avoid potentially more costly bounced check fees or vendor late fees. A significant problem with payday loans for consumers, and one that appears to be built into the profitability of many payday lenders, is their recurrent use. Perhaps 37 percent of borrowers use the products more than twelve times each year.[6]

Other studies show that 91 percent of payday borrowers use the loans five or more times with the average borrower taking out 8-13 payday loans each year.[7] Rolling over payday loans and other recurrent use may leave the borrower owing more in fees than the original balance of the payday loan.

The payday loan market has been dominated by rapidly growing stand-alone payday loan stores. Some banks, and even more credit unions, have been innovative in developing products that offer similar convenience at much more reasonable costs to the consumer and that sometimes include a savings component. Many bankers have been reluctant to expand or implement small-dollar loan programs, citing several concerns: 1) questions about the potential reputation risks; 2) perceived regulatory hostility; and 3) skepticism over the business case for such programs. In the view of some bankers, the business case for offering affordable, small-dollar loans may be undercut by comparison with the substantial income earned from fees collected through bounce protection programs, credit card loans, and from other, similar charges to consumers.

Overdraft Protection Programs: To provide coverage for occasional, temporary checking account overdraft, many banks automatically pay items drawn against insufficient funds and charge a per item fee for the overdrawn amount. While this type of overdraft coverage can be a valuable protection against late fees and other adverse consequences from bounced checks if used occasionally, repeated use can be very costly to consumers. In such cases, the fees and interest rates may far exceed those charged for payday loans.

In light of concerns about fee-based overdraft protection programs, the FDIC and other Federal banking agencies[8] issued Joint Guidance on Overdraft Protection Programs (Overdraft Guidance) on February 18, 2005. The Overdraft Guidance addresses safety and soundness and consumer protection issues, and explains "best practices" associated

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[5] See Sheila Bair, "Low-Cost Payday Loans: Opportunities and Obstacles," Report prepared for the Annie E. Casey Foundation at 6-7 (June 2005); Katherine Samolyk & Mark Flannery, "Payday Lending: Assessing the Importance of Scale to Store Performance," Preliminary Draft (October 3, 2006).
[6] See Sheila Bair, "Low-Cost Payday Loans: Opportunities and Obstacles".
[7] Center for Responsible Lending Study: Financial Quicksand: Payday Lending Sinks Borrowers in Debt, November 30, 2006.
[8] Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency and the National Credit Union Administration.

with overdraft protection programs. The "best practices" address ways that institutions should disclose information to customers, including identifying alternatives to overdraft protection, the costs of the various programs, and how to opt out of overdraft protection. In particular, under the Overdraft Guidance institutions are encouraged to monitor consumers' use and inform them of other, more affordable options on an on-going basis. One of those options should be an affordable small-dollar loan program that is consistent with the FDIC's Small-Dollar Loan Guidelines.

Successful Affordable Small-Dollar Loan Programs: There are a number of examples of successful small-dollar loan programs offered by banks and credit unions. Among these innovative programs is the North Carolina State Employees' Credit Union's SALO program, which provides members having direct-deposited paychecks with loans up to $500 with no fees, an APR of 12 percent and repayment at the next pay date. Perhaps most valuable in promoting savings and generating wealth, each time a SALO loan is granted, 5 percent of the advance is deposited into the SALO Cash Account and accumulates interest at passbook rates. This both reduces credit risk (by partially securing the advanced funds) and encourages the member to save. The SALO program has partnered with BALANCE, a consumer credit counseling service available free to credit union members. After advancing three SALO loans to a member, the credit union will recommend that the member receive counseling from BALANCE.

This is only one example. Citibank offers revolving lines of credit that are accessed if the customer overdraws their account or needs extra cash. The line of credit has a $5.00 annual fee and bears a maximum interest rate of 20.25 percent (in New York) and lower (in other states). Balances are repaid in monthly deductions at 1/60th of the balance (minimum $10.00) from customers' checking accounts.[9]

Some state governments also have sought to encourage development of small-dollar loan programs by banks and other credit institutions. One recent example is the "Better Choice" program initiated in 2006 by the Pennsylvania Credit Union Association (PCUA) with support from the Pennsylvania State Treasurer and the Pennsylvania Department of Banking. Under the program, participating credit unions offer 90-day loans of up to $500 with a savings component of an additional 10 percent of the loan balance deposited into a savings account. The loans have application fees capped at $25 regardless of loan size and interest rates cannot exceed 18 percent. Rollover loans are not permitted and the funds in this savings account cannot be withdrawn until the loan is repaid. The longer terms of the Better Choice loans as well as the savings component help encourage asset growth by credit union members. An additional feature that supports prudent financial decision-making is the requirement that participating credit unions offer financial counseling to borrowers.

Other Current FDIC Initiatives to Encourage Small-Dollar Lending Programs: The small-dollar loan pilot program is only one part of the FDIC's approach to addressing expanding consumer options for affordable small-dollar loans. The FDIC's approach is

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[9] For other examples, please review those noted on the website of the Center for Responsible Lending at www.responsiblelending.org.

designed to inform bankers about the value of small-dollar lending programs to their institutions and to the community. It also seeks to make consumers more aware of the benefits of affordable small-dollar loans offered by insured institutions and to provide consumers with the information needed to make a decision regarding which product is right for them.

The FDIC has already completed several initiatives to focus on insured institutions' involvement in affordable small-dollar lending. These include two conferences to discuss the lack of insured institution-offered, affordable small-dollar credit products and potential solutions and models insured institutions can use to create alternative products.[10] In addition, the following initiatives are underway:

- The Chairman and senior FDIC officials will continue to address economic inclusion and small-dollar lending in speeches and presentations to bankers and others.

- The FDIC is issuing final Guidelines to state non-member banks to encourage them to offer affordable small-dollar loan products. As a follow-up to the final Guidelines, the FDIC will be contacting all state nonmember banks with information about the final affordable small-dollar loan Guidelines and how the guidelines can be applied in their institution.

- The FDIC continues to work through the FFIEC to clarify the application of CRA performance tests for banking activities and products, including affordable small-dollar loans, which provide credit and other support in underserved markets.

- The FDIC Advisory Committee on Economic Inclusion considered small-dollar lending issues at its inaugural meeting on March 28, 2007 and recommended the pilot program. The Committee will continue to review areas related to improving access to the financial system.

- The FDIC's Alliance for Economic Inclusion includes nine regional advisory committees consisting of bankers, nonprofits, local government groups, and regulators that will discuss general issues of economic inclusion, beginning with affordable small-dollar lending.

- The FDIC will publish articles tailored to bankers regarding ways that insured institutions can safely and profitably expand access to the financial mainstream, including through provision of affordable, small-dollar loans.

[10] September 29, 2005 FDIC Conference on Affordable, Responsible Short Term Credit and December 6, 2006 Affordable and Responsible Loans for the Military: Programs and Prototypes.

- The FDIC will devote one or more issues of the *FDIC Consumer News* to safe and sound affordable small-dollar credit, focusing in particular on how consumers can research alternatives and compare costs.

- The FDIC is preparing a consumer portal for internet information on affordable small-dollar lending and a consumer brochure, again focusing on how to research and compare costs of competing products.

The Pilot Project

The project is designed to demonstrate how small-dollar loans can be an effective part of a bank's business plan to reach out to underserved communities and to develop new customers for mainstream banking services. The key to this project is to encourage institutions to innovate and experiment with providing safe and sound affordable and profitable small-dollar loans consistent with the FDIC Small-Dollar Loan Guidelines. By encouraging innovation, the FDIC hopes to gather information and case studies to identify the most effective strategies for banks to provide affordable small-dollar loans to consumers. These strategies will be widely disseminated to banks to serve as a resource for the development of new bank-initiated small-dollar loan programs.

Eligibility for Participation

Volunteers for the pilot program must be well managed and well capitalized institutions, and will be screened for participation to ensure that there are no outstanding concerns regarding enforcement actions, fair lending, money laundering, or other regulatory investigatory actions. Financial institutions interested in participating will provide a description of their existing or proposed small-dollar loan program to the FDIC. The description will be reviewed by a FDIC selection panel. To provide more meaningful information about the pilot's success, the group of participating institutions should consist of various sized institutions and in widely dispersed geographic locations.

Description of Recommended Components for Small-Dollar Loan Programs

The FDIC Pilot Project is premised upon evaluation of the small-dollar loan programs developed by bankers in order to identify best practices that can be replicated by other banks and thrifts. As a result, an important component of the Project is consideration of a multiplicity of different business models that offer reasonably priced loans. While the FDIC pilot is seeking variations in business models, the following provides a general framework for an acceptable, affordable small-dollar loan program.

Underwriting
In order to attract borrowers who might otherwise obtain loans at payday lenders, the pilot allows participating institutions to use streamlined underwriting criteria for their small-dollar loan programs. As such, the only requirements would be that the small-dollar loan customer have a current relationship with the institution (so that the customer

would have met the Customer Identification Program (CIP) requirements); have proven ability to repay the loan; and have no current or prior defaults at the institution.

Small-Dollar Loan Program Criteria

Interested institutions should provide a program description that explains the current or proposed structure of the program; current or projected size of the program; marketing efforts; the application process and underwriting standards; and interest rates and fees.

Regardless of whether the institution proposes an existing or new program, in order to participate in the pilot, the FDIC has identified certain criteria that it considers to be consistent with an affordable, safe and sound small-dollar lending program. While the FDIC encourages innovation in developing small-dollar lending programs, desired components include the following:

1) Amortization period –
    i) for closed end credit: up to 36 months;
    ii) for open end credit: minimum payments should repay principal, i.e., product should not allow for negative amortization;
2) Interest rate – Below 36% annual percentage rate (APR);
3) No prepayment penalty;
4) Origination and/or maintenance fee(s) limited to amount necessary to cover actual costs; and
5) Automatic savings component for consumers.

The FDIC is particularly interested in programs that contain an automatic savings component. The pilot program is designed to demonstrate that small-dollar loan products can be linked to asset building programs that over time may help reduce a consumer's reliance on short term, high-cost credit. The linked savings component can be structured so that 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. If necessary, the funds in this account can serve as a pledge against the loan, as permitted by law.

Information Collection

In order to evaluate the success of the small-dollar loan programs at participating institutions, and to inform the industry and the public of the results of the pilot, the FDIC will work with the institutions to collect information about the overall value and profitability of the programs and their use by consumers. Approximately 40 days after the end of each quarter during the pilot, each participating institution will provide information regarding the small-dollar program to the FDIC using the FDIC*connect* data interface system. The purpose of the information collection is *not* to subject participating institutions to additional examination scrutiny. In fact, participating in the small-dollar pilot will have no effect on examination frequency. The information collection will be subject to industry comment under the Paperwork Reduction Act.

Among the items of information that the FDIC may be seeking to collect are the following:

1. Information about the loans in the Program
    a. The total number and total dollar amount of loans.
    b. Average loan term and average dollar size of loans.
    c. Average interest rates charged, average fees levied, and average calculations of APR (as required by the Truth-in-Lending Act).
    d. Aggregate delinquency, charge off, and workout refinancing data.

2. Information about the business value of the Program
    a. Profitability and/or break even data for the overall Program.
    b. Profitability of the overall customer relationship (especially if the customer migrated into other products)
    c. Information regarding whether customers of the Program migrated to other bank products.

3. Information about the benefit to consumers
    a. The total number and total dollar amount of linked savings accounts opened as part of the Program.
    b. Information as to duration and withdrawal rates of the linked savings accounts.
    c. Information regarding whether customers of the Program continued to use payday loans or other high-cost debt products.

Benefits to Institutions Participating in the Pilot

Community Reinvestment Act Consideration

Establishing a loan program in an institution's assessment area that provides small, unsecured consumer loans that are consistent with the Affordable Small-Dollar Loan Guidelines would warrant favorable consideration by the FDIC under the CRA as an activity responsive to the credit needs of many communities. Moreover, programs that transition low or moderate income borrowers from higher cost loans to lower cost loans are particularly responsive to community needs. Consequently, offering lower cost alternatives to such borrowers will also be viewed by the FDIC as particularly responsive in the CRA examination. Finally, where small-dollar loan products are combined with a low-cost savings account, institutions may also qualify for favorable consideration for providing community development services.

Profitably Expanding Into New Markets

Institutions can potentially use the small-dollar loan pilot to tap into new markets by expanding relationships with individuals who currently may not be fully utilizing the mainstream financial system. Estimates of the size of this market vary, but indicate that as many as 40 million individuals may be unbanked or underbanked. Moreover, estimates for the payday loan industry indicate that loan volume exceeds $28 billion per year and is growing rapidly. Banks already have a relationship with payday loan customers, since an individual must have a checking account to receive a payday loan. Therefore, banks can use the pilot to explore whether some segment of those customers can be profitably migrated into credit products. In addition, the institution can use the funds accumulated through the mandatory savings component as a funding source while the customer's loan is outstanding.

Community Goodwill

An intangible benefit that may accrue to institutions participating in the small-dollar pilot is the community goodwill that will likely be created as a result of offering consumers credit products with significant savings over payday loan fees. Additionally, while the FDIC is unable to endorse a particular product or institution, the FDIC Board will be briefed periodically on the pilot project at Board meetings open to the public and the press. A press release will be issued that will likely include the names of participating institutions. As the project progresses over the two-year period, we anticipate periodically revisiting the pilot and publishing results that will continue to highlight institution's participation.

Timeframes: This pilot program could begin once the Paperwork Reduction Act requirements are met (approximately 90 – 120 days after the initial publication in the Federal Register).

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