



FDIC Lending Program Risks Reducing Financial Choice for Consumers

CRL Advises Real-World Changes To Small-Dollar Loan Pilot Program

On August 14, 2008 the government's Federal Deposit Insurance Corporation (FDIC) released the first data from banks participating in its Small-Dollar Loan Pilot Program. The Consumers Rights League (CRL) supports efforts to empower consumers, especially those whose credit profiles classify them as "subprime," by identifying best practices in lending options that will eventually drive down the cost of capital. However, CRL has identified numerous problems with the pilot that fail to serve the needs of low-income consumers who need inexpensive access to short-term capital. CRL recommends that the FDIC consider additional options to meet consumers' real-world needs.

About The Small-Dollar Loan Pilot Program

In February 2008, the FDIC chose 31 banks to participate in a pilot program. The stated goal of the program was 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." The program specified criteria for longer-term loans and low interest rates. As an incentive for banks to participate, FDIC has announced that it would view participation very favorably for banks reviewed under the Community Reinvestment Act. Thus, financial institutions had an incentive to conduct such a program even if its operations were not truly profitable. This could have the effect of distorting cost-benefit analysis of the program's effectiveness.

Initial Findings From The Pilot Program

A few important insights from the government's initial data on the lending pilot program merit consideration:

- The program specifies that loan periods must extend beyond a single paycheck cycle, essentially replacing short-term loans with longer-term loans. When the FDIC split the data between loans under and over \$1,000, it found that the average loan amount for loans under \$1,000 was \$678 -- about twice the normally stated amount of a payday loan -- and the average loan term was 10 months. These terms may suit some financial institutions, but may still fail to meet the immediate needs of many.
- The FDIC "indicated a particular interest in programs with automatic savings features," which tend to discriminate against truly poor borrowers for whom saving is not the best option at a given time. The FDIC found that "All of the saving programs indicated that

the savings accounts would partially collateralize the loans and specified limits on withdrawal." These and related requirements discussed in the FDIC report often involve time-consuming credit checks or other investigations that may not suit all consumers' unique situations.

- Of note was the disclosure that participating banks "targeted" certain groups: low- and moderate-income individuals; military personnel; college students; Latinos; and Native Americans. Some self-titled consumer advocates attack lending institutions that market loan products to these demographics. The participating banks in this case confirm that marketing products to these groups is appropriate.
- The FDIC report repeatedly mentions the potential for long-term relationship building through small-dollar loans and highlights "opportunities for cross-selling other products, which creates significant potential for building profitable customer relationships."

Further Discussion

The FDIC's pilot program is laudable only insofar as its stated objective is to assist consumers. Unfortunately, the fundamental problem with the FDIC's program design is in its attempt to seek a "profitable" model while ignoring the realities of short-term borrowers. Despite its best intentions, the pilot's design appears to better serve the needs of traditional banks and traditional customers rather than subprime consumers who need inexpensive access to short-term capital.

Application Fee: Some pilot participants incorporated application fees for their loans, ranging from a low of \$18 to a high of \$61.50 and an average of \$34. These costs should be incorporated into the total cost of the loan, but are not. Consequently, the real interest rates in the pilot are higher than they appear. For instance, a \$34 fee would increase the cost of the average small-dollar loan in the pilot by five percentage points. It is possible that after including application fees the resulting real interest rate could exceed the program's rate cap. Fees that can be anywhere from \$18 to \$61.50 may well cost more than current payday products, depending on the size and length of loan. This oversight further reduces the usefulness of APR ate caps, which are already an inappropriate measure for short-term products.

Loan Terms: As noted above, the average amount of small-dollar loans in the pilot program was approximately double the average for "payday" loans. The length of loan was 20 times greater. These are not necessarily terms that are beneficial to all consumers, many of whom actively seek out shorter-term and more anonymous relationships. These facts, combined with the program criteria that loans exceed a paycheck cycle, diminish the pilot's usefulness in testing profitable models for "short term" lending.

Credit Score: Those participating banks requiring long-term relationships may require credit checks, which would restrict participation by consumers with low credit scores. Instead, the plan serves only to further increase the number of products available to consumers who already qualify for traditional offerings. By preventing uptake in the plan by individuals with lower credit ratings, the FDIC reduces the pilot's relevance to meeting the real-world needs of consumers and fails to find new ways to provide greater access to inexpensive capital for low-income individuals and non-traditional customers.

Mandatory Savings: Many banks in the pilot used their participation as an opportunity to cross sell profit-driving savings accounts by mandating them as part of their plan. This is a blatant attempt to collateralize loans and therefore acts as a barrier to meeting the real-world needs of many consumers who do not have or wish to utilize sufficient capital to collateralize a small-dollar, short-term loan. In effect, the capital from banks mandating savings plans will only be accessible to those with current savings accounts, or it will force people to borrow more money than they need. This is a significant impediment to the plan's usefulness in creating an alternative to the current short-term lending model.

Cross Promotion: Most pilot participants did not report on their profitability, but of the five who did, three broke even and two lost money. A high percentage of participating banks offer loans only to existing customers, which does not help the unbanked or those who would fail to qualify for traditional products. This may meet the needs of traditional institutions that can leverage these into profitable long-term relationships, but replacing the current model with the FDIC pilot would reduce access to capital for millions. This model would essentially drive consumers to escalate their borrowing and increasing their debt, rather than simply helping them with a short-term need for cash.

Conclusion

Federal researchers interested in increasing short-term lending options would be best served to consider altering the FDIC pilot program guidelines to meet consumers' real-world needs. First, there is no apparent reason to require that the length of loans to exceed one paycheck cycle. This needless extension of loan length makes the products less useful for many individuals. Second, the FDIC's criteria for an interest rate cap based on an Annual Percentage Rate does little to assist customers who require a short-term loan for which annual figures are not helpful. Third, the FDIC should collect better data on overall cost of loan products in its program as the current data contains a confusing array of potential fees levied by participating banks.

The Consumers Rights League applauds the FDIC for its attempt to spur product and service innovation in small-dollar lending. All consumers benefit when more products and more competition are introduced into the marketplace.

At the same time, CRL is concerned that the FDIC may be undertaking efforts that assist financial institutions that fall under its purview at the expense of organizations that are less traditional but possibly more innovative. Legislators, regulators, and government researchers serve consumers best when they increase, rather than decrease, the number of financial options available. The FDIC can and should improve its pilot program by altering its criteria and mission to reflect the benefits provided by expanded consumer choice.

About The Consumers Rights League:

The Consumers Rights League is a non-profit, non-partisan educational organization dedicated to protecting consumer choice and access to the marketplace. Through investigative analysis, CRL produces quality research that thoroughly documents the real-world choices and challenges consumers face and reports on the benefits enjoyed by an overwhelming majority of consumers. Learn more about CRL's mission at www.consumersrightsleague.org.