Memorandum To:	**Members of the FDIC Advisory Committee for Economic Inclusion**
From:	**Steven O. App** **Deputy to the Chairman and Chief Financial Officer** **Michael H. Krimminger** **Special Advisor for Policy**
Date:	**February 27, 2007**
Subject:	**Expanding the Availability of Reasonably-Priced Small Dollar Loans: Staff Proposal for a Pilot Project**

Overview

Staff proposes that the FDIC establish a pilot project to demonstrate the commercial viability of reasonably-priced small dollar loan products. The proposed project will offer options for incentives to banks for participation and a menu of suggested features for small dollar loan products to be offered at a reasonable cost to consumers.

This staff proposal will be presented to the Committee at the March 28, 2007 meeting. At that time, we will be seeking your advice and recommendations on the proposal. As a result of the open meeting requirements, any written comments you choose to provide in advance must be made available to the public.

Background

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 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 rollover the loan (or a portion) which results in another round of fees. If the customer fails to appear, the payday lender can deposit the check or undertake other collection efforts.[1]

A major perceived advantage of payday loans to the consumer is the immediate availability of funds. 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. 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. 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. A few 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. Most 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.

The staff proposals for a FDIC-sponsored pilot project are designed to demonstrate the viability of such programs as a component of a business plan to reach out to underserved communities, develop new customers for mainstream banking services, and reduce consumers' reliance on high-cost, non-bank service providers.

Research suggests that banks have certain inherent advantages in providing lower cost, small dollar loans over payday loan stores. First, banks have the preexisting infrastructure to serve these consumers and can avoid the significant fixed costs that opening new, stand-alone payday loan stores entails – including advertising, rent, and payroll. Banks, unlike payday loan stores, also can recover their fixed costs over a range of products. Estimates suggest that the per-loan cost for payday lenders are in the range of $25 for established stores and $36 for stores open less than four years.[2] In addition, the cost to make new loans to existing payday loan customers is considerably lower than the cost to attract new customers. As a result of these characteristics of payday loan stores, loan volume and repeat business are key determinants of payday lender profitability. All else being equal, the discussion above would suggest that banks have a cost advantage over traditional payday lenders in making small dollar loans and that this could lead to lower costs for consumers.

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1 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).
2 See Bair at 28-29; Samolyk & Flannery at 11-12. This includes the costs of loan defaults and collection efforts.

Second, banks are in a superior position to minimize credit losses through direct deposit, automatic repayment, and the availability of better data about their account holders (such as overdraft histories).[3] These features also serve to reduce banks' per loan expenses for repayment compared to payday lenders' primary reliance on customer traffic for repayment.

Third, banks can offer a variety of products that build revenue through a longer-term relationship with the customer. One issue noted by some studies is that some payday loan borrowers are not comfortable seeking credit from banks. Overcoming this negative perception will require reaching out to consumers and to community groups to provide a more welcoming environment for consumers, as well as to demonstrate the lower cost of banking products.

Fourth, banks can offer better customer privacy, convenience, and financial growth through products in the form of revolving lines of credit linked to deposit accounts. Products such as the North Carolina State Employees' Credit Union's Salary Advance Loan (SALO) program can be building blocks for development of consumer savings.

A Sample of Successful 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 with direct deposited paychecks with loans up to $500 for no fees, an APR of 12 percent and repayment at the next pay date. Perhaps most valuable in promoting savings and wealth generation, 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. Rollovers of existing SALO loans actually increase both the credit union's collateral and the consumer's savings. The SALO program has partnered with BALANCE, a consumer credit counseling service available free to credit union members. After three SALO loans, the credit union will recommend that the member receives counseling from BALANCE.

This is only one example. Banks, such as Austin Bank of Chicago and LaSalle Bank of Chicago, offer similar products. Some larger banks, such as Citibank, offer 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.[4] There are other examples, but it is unfortunate that more financial institutions do not offer reasonably-priced payday loan alternatives.

Some state governments have sought to provide incentives to encourage development of small dollar loan programs by banks and other credit institutions. One recent example is the "Better

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3 Federal Reserve Regulation E prohibits requiring automatic repayment by electronic means on a preauthorized, recurring basis, but the regulation does allow banks to offer financial incentives to encourage the use of automatic repayment.

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

Choice" program initiated in 2006 by the Pennsylvania State Treasurer with support from the Pennsylvania Department of Banking and the Pennsylvania Credit Union Association (PCUA). 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.

In order to encourage participation, the Pennsylvania Treasurer deposited $20 million of state funds in the PCUA's credit union. The PCUA chose this option because its members did not want to manage smaller deposits in individual credit unions. While the program is now just getting underway, more than 45 credit unions in Pennsylvania have agreed to participate.

Although designed to achieve broader objectives, another example of a creative approach to making reasonably-priced banking services more available is the "Enriched Banking Development District" program in New York. Although the program predated her tenure as New York State Banking Commissioner, Diana Taylor was instrumental in developing and expanding the program. In late 2004, she formed the Banking Development Working Group and included members from New York City and State governments along with community development experts. The Working Group sought to expand access to banking in specific communities by providing incentives for banks to open branches with products and services to meet the communities' specific needs. In short, the "Enriched Banking Development District" program provides public deposits from New York City and New York State at below market rates along with other at-market public deposits. Other available public incentives include property and other tax breaks, favorable CRA consideration, assistance in locating branch sites, and other incentives. Banks seeking to participate in the program must apply to the NYS Banking Department and define specific products and services that will meeting community needs not currently served by other financial institutions. The program appears to have achieved significant successes. Branches opened under the program have been actively involved in providing financial literacy training and have introduced new services and products, including new ATMs, free application assistance for Earned Income Tax Credits, and extended hours, to meet community needs. The program has now been expanded throughout New York state.

FDIC Draft Small Dollar Loan Guidance

On December 4, 2006, the FDIC issued for comment guidelines to state non-member banks to encourage them to offer affordable small-dollar loan products. FDIC-supervised institutions that offer these products in a responsible, safe and sound manner may receive favorable consideration under CRA. The draft guidance suggests ways the banking industry can make affordable short-term loan products more accessible to these customers, helping to build long-term, profitable multiple-account relationships. In the proposed guidance, the FDIC encourages banks to offer products with affordable, reasonable interest rates with no or low fees; repayment schedules that pay down the principal balance of the loan; and a savings component incorporated into the loan product. In addition to a savings component, banks are encouraged to include financial education for frequent borrowers. The FDIC also encouraged banks to leverage technology in managing these products.

The comment period on the guidelines expired on February 2nd. A review of those comments demonstrates broad support for the guidelines, including a limitation on interest rates for such products. Most commenters also agreed that small-dollar loan products should provide an affordable installment repayment schedule longer than a single paycheck cycle, minimal or no fees, and a savings component. The FDIC anticipates finalizing the guidance during the 2nd quarter of 2007.

Military Lending Conference

On December 6, 2006, the FDIC hosted a conference, entitled "Affordable, Responsible Loans for the Military: Programs and Prototypes," with bankers and community groups focused on meeting the needs of military personnel and their families. The enactment of the Talent-Nelson amendment earlier in 2006 highlighted growing concern about the impact on our military personnel of frequent use of high-cost providers for short-term loans and other financial services.

The banks that attended the conference developed a template for an affordable, small denomination loan product with a savings component. The template provides for loan amounts up to $1,000 with repayment periods of up to one year, interest rates in the 12-18 percent range, no prepayment penalties, and low or no origination fees. The template also includes a mandatory, accumulating savings component of 5 percent or more of each payment to build assets and sources of future repayment along with direct deposit of some or all of the borrower's paycheck. An additional feature of the template is strong encouragement for financial institutions to provide financial education to service members and their families. These features already provide a number of banks focused on the military market with profitable products and, more importantly, with growing longer-term relationships with borrowers. We believe that loans with the features in the template developed at the Conference can be viable components of responsible lending to all borrowers.

Outline of Staff Proposal for FDIC Pilot Project:

The following staff proposal for a pilot project to demonstrate the value to banks of incorporating reasonably-priced small dollar lending programs into their consumer product offerings is designed around several key elements:

- Participating institutions would serve as depositories for FDIC deposits at market or below market rates. If FDIC deposits are made available, staff proposes that the FDIC consider making available up to $30 million from current overnight accounts for deposit in participating institutions.
- Participating institutions would warrant favorable consideration under the Community Reinvestment Act as an activity responsive to the credit needs of the community.
- Banks interested in participating will be selected based on a simple, transparent, and

streamlined process using objective criteria.
- The FDIC will verify adherence to the guidelines for the lending program as part of its normal examination process to limit any burden on participating banks.
- The project will provide a small dollar loan template that will allow participating banks to exercise considerable flexibility in designing a program that best meets their needs. Several of the possible options that may be selected by banks are described below. These options, however, are not meant to be an exhaustive list. We recommend that the FDIC should encourage innovation and experimentation within the parameters of the template guidelines.

There are additional features that are recommended by the literature and by discussions with researchers and other interested parties. First, outreach will be crucial. Discussions with a number of individuals emphasized the key element of outreach to underserved communities and the role that community groups can play in success of the pilot. Our relationships with community groups could be crucial to getting the word out about the project and its benefits to consumers.

Second, a variation on this approach would use "community groups" of bankers by seeking to develop a partnership with a banking trade organization. Some trade groups have separate corporate organizations designed to provide services to members that could serve as vehicles to administer the pilot. This approach could be similar to that used in the "Better Choice" initiative in Pennsylvania – a deposit from the State Treasury was placed into the credit union for the Pennsylvania Credit Union Association and used as seed money to support credit unions participating in the payday loan alternative.

Possible Incentives for Participating Banks

The principal challenge in developing a successful pilot for small dollar loan programs is determining the appropriate level and mix of incentives that will encourage bankers' participation, but also will not impair the demonstration to the banking industry of the commercial viability of affordable small dollar loan products. That is, if the incentives we offer are deemed too generous by objective observers, they will attribute any program success to the deposit earnings subsidy or CRA credits, rather than to the commercial viability of the small dollar loans.

Discussions with researchers and bank representatives indicate that a "menu" approach for incentives may be the most useful because, for example, below market deposits may be more important for some institutions, while CRA credit may be more important for others. Other banks may prefer to participate by providing funds (either directly or through FDIC-placed funds) to an "administrative" bank that makes and manages the loans. An *a la carte* approach for participating banks will give them some flexibility to design the optimal package of incentives.

Staff seeks the advice of the Committee on the level of incentives that may be appropriate to encourage participation by banks in the pilot project. One possible incentive is the placement of FDIC funds in participating banks either at market or below market rates of return. Staff would prefer to offer such funds at current market rates for 2-year funds, but would appreciate the Committee's views on whether this will encourage adequate participation in the pilot.

Alternatively, the FDIC could provide an incentive similar to that used in New York's Enriched Banking Development District program and Pennsylvania's Better Choice program. This would entail the placement of FDIC funds in the participating banks at below market rates. To protect the security of the funds, all deposits in excess of $100,000 would be collateralized. For example, the FDIC could offer the funds to participating banks as a 2-year commitment at 2-3 percent below current market rates for funds deposited for similar terms. To provide some context on the rates currently paid by insured institutions, a review of certificate of deposit rates as of February 27, 2007 reveals a wide range with internet rates ranging to 5.26 percent for 2-year CDs in excess of $95,000 while some more community-based banks report rates in the range of 4.11 to 5.12 percent. Bankrate.com reports the average annual percentage yield nationwide is 5.03 percent.[5] Based on the state government experience, this incentive will encourage participation by providing lower cost funding through a stable two-year deposit.

As noted above, participating banks also would receive favorable consideration under the Community Reinvestment Act for engaging in an activity responsive to the credit needs of the community.[6]

Staff also recommends that the pilot project consider applications both from single institutions and from consortia of institutions, who may agree to pool the proffered deposits and share the resulting incentives. The pooling of resources may allow multiple banks to offer small dollar loans through a single, community-based institution, a so-called administering bank, and may also allow more rapid expansion of such products in underserved communities. This approach may increase the size of the lending program without requiring additional collateral to be pledged by the administering bank since the FDIC's funds would be separately insured at the other members of the consortium.

A similar pooling approach is used by the Community Investment Corporation (CIC) in Chicago to promote the availability of mortgages in underserved communities. This approach involves four steps: 1) investors pledge funds, 2) CIC issues mortgages, 3) CIC sells notes to investors who are now obligated to purchase, and 4) investors share in revenue stream and CRA benefits. This model could be used for bank "investors" for small dollar loans and the purchase of note interests would ensure that the "administering" bank did not have to bear full exposure on resulting assets. This approach has been used in a number of programs, such as affordable housing, dating back to the 1970s and will be used in the Alliance for Economic Inclusion (AEI).

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5 Information reported was identified in a search of Internet information on February 27, 2007. Community-based bank rates reflect reported information for institutions based in Chicago, Illinois (LaSalle Bank, Harris Bank, and Liberty Bank for Savings).

6 See Interagency Questions and Answers on the Community Reinvestment Act, 66 Fed. Reg. 36619, 36631, Sec.345.22(a)-1 (July 12, 2001), http://www.fdic.gov/news/news/financial/2001/fil0164.html. The federal banking agencies confirmed that establishing loan programs that provide small, unsecured consumer loans in a safe and sound manner (i.e., based on the borrower's ability to repay) and with reasonable terms may warrant favorable consideration as activities that are responsive to the needs of the institution's assessment area(s). While this clarification refers to the CRA lending test for large institutions (institutions with assets over $1 billion), the FDIC takes a similar view for all other institutions.

Suggested Features for Affordable Small Dollar Loans for the Pilot Project
The staff proposal for a pilot project seeks to harness the creativity of bankers by allowing participating institutions to design individualized small dollar loan programs within broad parameters laid out by the FDIC. As a consequence, participating institutions should be encouraged to design a program that incorporates certain key features but offers the institution flexibility in their specific content and implementation. As described below, staff recommends that the FDIC evaluate and select applying institutions for participation that offer optimal combinations of these suggested features.

Building on the principles identified in the FDIC's Small Dollar Loan Guidance and on the input provided by participants at the FDIC's recent military lending conference, staff recommends that the FDIC seek applications by institutions that propose programs with the following broad features:

Loan Amount – up to $1,000. Most short term "emergency" loans are in the $500 range, but higher loan amounts may be permissible with further underwriting. There also are a number of options for delivery of the loan funds. Among the possibilities are normal consumer loans and lines of credit.

Amortization period – Longer than a single pay cycle and up to 12 months. Affordable, amortizing payments made over a suitable period of time (1) are preferable to repeated, consecutive and increasingly costly loan balance renewals that may occur with payday or other loans, and (2) provide the bank with an extended opportunity to cross-sell asset-building products beneficial to both the customer and the bank.

Interest Rate – Below 36 percent APR. The experience of several lenders at the military conference indicated that products with interest rates between 12 and 18 percent offered some initial profit, but more importantly lower rates fostered the beginning of a profitable, long-term, multiple-account relationship.

No prepayment penalty. The loan amount is small, the term is relatively short, and it is held in the bank's consumer loan portfolio. There is no call for a prepayment penalty.

Low or No Origination Fee. A reasonable and low-cost origination fee may help to cover costs in some cases, but in any event should bear a direct relationship to actual origination costs. In other cases, an origination fee may not be necessary or desirable.

Mandatory Savings Component – 5 percent or more of the loan payment. A steady increase in savings with a tandem reduction in debt (1) provides the borrower with a source of a payment if a payment can not otherwise be made, (2) builds assets and a financial cushion to meet future emergency needs without borrowing, and (3) provides the bank with an anchor to continue the customer relationship after the loan is repaid.

Direct Deposit & Internet or Telephone Banking. A checking or statement savings account with direct deposit of some or all pay, and the ability of the borrower to transfer payments from the account to the loan by internet or telephone, provides (1) convenience to customers, (2) improves the likelihood of timely repayment to the bank, and (3) locks in a profitable, long-term customer relationship.

Prompt Loan Application Processing. The application and approval process should take no longer than it takes a payday lender to make a pay day loan. An automated application, approval, and loan disbursement process would provide fast service to customers as well as lower an institution's origination costs. Existing deposit customers may already have been screened by the institution's customer due diligence program and, as a result, detailed underwriting may be unnecessary. Seasoned customers may be pre-screened for a small closed-end, amortizing credit, or a small open-end line of credit with amortizing monthly payments. Current “leave and earnings” statements should be readily available for employment and income verification.

Financial Education and Asset-Building. Financial institutions also should make every effort to provide financial education to customers requesting small-dollar loans. Improving financial skills can help consumers reduce reliance on short-term, emergency credit and build savings and other account relationships. The FDIC’s Money Smart program and similar financial education resources are examples. Moreover, institutions that monitor borrower use of credit, and offer financial counseling or education when signs of financial stress are detected, will help them become better customers.

Project Administration and Selection Criteria

Staff recommends that project administration be kept simple, but include four elements: (1) a defined application process for participating banks, (2) an approval process, (3) a disbursement process, and (4) a monitoring process. In doing so, it is essential that these processes be streamlined, automated, and accompanied by appropriate controls to ensure the cost of the project is minimized, and that it meets the project’s stated objectives.

Application Process for Participating Banks. The application process must be simple, transparent, and accessible to ensure a wide range of eligible institutions apply. The approval criteria for selection of participating banks must be clearly defined and objectively applied to ensure the process can withstand external scrutiny.

We recommend that all applicants should be highly rated and well-capitalized institutions. In addition, all applicants should affirm that: (1) similar products are not available in the local lending market (because our project should not compete with small dollar, lower cost loan products offered by other federally-insured banks), and (2) their loan product will meet consumer credit needs at a reasonable cost.

Approval Process. The approval criteria for selection of participating banks must be clearly defined and objectively applied to ensure fairness and reliability. Applying banks should be evaluated and selected based on the inclusion of key elements of the suggested features for small dollar loan programs identified above. The inclusion of each element will award the applicant one point and selection will be based on total points. This will provide identifiable and objective selection criteria.

In order to promote applications and participation by a diverse group of insured banks and thrifts, we recommend that a cap be placed on the amount of funds that may be provided to any one institution.

Disbursement of Funds. To ensure the ongoing integrity of the project, the disbursement of FDIC funds to participating banks and approval processes must be segregated within the FDIC.

Monitoring. Finally, staff recommends that the FDIC should set up a simple monitoring process to ensure the participating banks are adhering to the guidelines of the project and to gauge its success in achieving its objectives. This could take the form of direct review by FDIC employees, oversight by a third party contractor, or through some type of self reporting by the participating banks themselves.

Questions for Committee Consideration and Discussion:

Staff requests that the Committee members consider and provide advice on the proposed pilot project. In particular, staff requests consideration by the Committee members of the following issues:

Proposed Incentives:

- What level or mix of incentives will encourage active participation in the pilot project by a diversity of banks?
- Will the deposit of FDIC funds at market rates be an effective incentive? Is it necessary to provide the deposits at below market rates?
- Will the requirement of collateralization be a significant disincentive?
- Will favorable Community Reinvestment Act consideration be a valuable incentive for participation by bankers? What additional options should be explored?
- Are the proposed incentives too generous? Will they be viewed as impairing the demonstration that reasonably-priced small dollar loan programs are viable parts of a bank's business plan?
- Does the proposed use of up to $30 million in FDIC funds for deposit over a two-year period provide the optimal size and scope for the project?

Pilot Program Features:

- Do you suggest any changes to the proposed features for small dollar loan programs identified on pages 8 and 9?
- Are there other features for small dollar loan programs that should be included?
- There are a variety of options for delivery of small dollar loans to consumers. Among the possibilities are normal consumer loans, credit cards, and lines of credit. Should the program be limited to specific types of delivery methods?
- Do these features provide sufficient or too much flexibility for small dollar loan programs under the pilot project?
- Should applications be considered both from single institutions and consortia of institutions?

Administration:

- Are there other criteria that should be applied for selection of participating institutions?

Communications:

- What are the optimal ways to communicate the FDIC's goals and interests in promoting the pilot project?
- What are the optimal ways to communicate the FDIC's goals and interests in promoting expanded availability of reasonably-priced small dollar loan programs at banks?