Sheila C. Bair
[redacted]
Kennedyville, MD 21645

January 22, 2019

The Honorable Jelena McWilliams
C/O Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW, Washington, DC 20429
RIN 3064-ZA04

Dear Madame Chairman:

Thank you for the opportunity to provide comments to the FDIC as you consider how to encourage small-dollar lending by banks. This is a subject of great importance to me. When I led the FDIC, we conducted a two-year pilot program on small-dollar lending in 2008-2009. Before that, I published research sponsored by the Annie E. Casey Foundation on the payday loan market and how banks and credit unions could better compete in this market to meet the needs of their customers and drive down borrowing costs. I welcome your request for information on how the FDIC can continue important work in this area.

I wrote in 2005, "depository institutions have the tools and infrastructure that they could deploy to offer their customers low-cost alternatives to payday loans. Whether they are willing to enter this market remains to be seen." The first statement was true then, but with technological advances since 2005, it is even more so today. Based on developments over the last several years, it appears that banks' interest in this market has grown substantially. That is good for consumers, because the market for small installment loans is still in desperate need of more competition.

In the 2005 paper, I noted that "depository institutions may be in a better position to minimize credit losses through the use of direct deposit and automatic deduction for payment." This is also even more the case today, where banks can prescreen customers more easily for eligibility and consumers can agree to electronic payments through mobile or online banking. Though the Deposit Advance programs offered through early 2014 by a number of banks had fatal flaws—chiefly large balloon payments and very high prices—they did crack the nut of low-cost origination. Customers could apply quickly through online banking for advances, they were approved almost instantly, and funds were deposited in customers' accounts within minutes. Speed is vital to the success of small installment loans from banks, both to keep costs down for providers, but also to keep customers from turning to payday lenders who compete more on speed than on price.

Though small-dollar lending from banks has not yet grown sufficiently to replace payday, auto title, and other high-cost lending, we have learned a great deal since I studied this topic as an academic. The FDIC Small-Dollar Loan Pilot that we ran in 2008 and 2009 was especially instructive. My biggest takeaways from that pilot were as follows:

1) Banks will Offer Small Loans if They Can Do So Profitably

Payday lenders have argued that banks are simply not interested in offering small loans and will not do so. The fact that banks participated in the pilot, commented to the CFPB on its small-loan proposal in 2016, and have expressed interest in offering small installment loans recently, all indicate that the payday lenders' belief is unfounded. But small-dollar lending has unique challenges that are different from core bank products.

First, small-dollar lending offers only modest revenue on each loan, so banks have to minimize costs to be profitable. Second, these loans are mostly appealing to customers with low credit scores who would not qualify for mainstream products under conventional lending standards. Third, these loans tend to require rates that are higher than those on credit cards in order to be profitable. That has created uncertainty around exactly what rates are acceptable and make sense for both providers and consumers. Under the pilot, profitability assessments were subjective, and many participants did not assess whether small-loan programs were profitable on a standalone basis. But based on the pilot, and subsequent conversations and comments in roundtables and other events on small-dollar lending, bankers have been clear that they are more than willing to develop higher-volume small-dollar loan programs if they can offer these loans in a profitable way.

2) Simple, Streamlined Underwriting and Origination are Necessary

The pilot encouraged streamlined underwriting with a credit report, and a loan decision within 24 hours. A decade ago, these requirements made sense. The goal of the pilot was to encourage underwriting methods that were less time-consuming and costly than those used for larger loans and to fund loans quickly. But with new research on borrowers and new technology available to expedite underwriting and decisioning, the landscape is different today. Academic research released subsequent to the pilot's launch has found that using specialty alternative credit bureau data can be better at predicting repayment than traditional credit scores. Similarly, a number of third-party service providers to banks and credit unions now use automated underwriting that incorporates account history and other information not available in a traditional credit report. Some feedback from pilot participants was that they appreciated flexibility in developing underwriting criteria that met their needs.

It has also become even more clear that tragically, consumers in dire financial straits focus primarily on how quickly they can get money rather than how much a loan costs or how well the payments fit into their budgets. Payday lenders have responded, often approving applications and funding loans in 15 or 20 minutes. The 24 hours for a loan decision that the pilot encouraged was unusually fast at the time, but things have changed. Service providers to banks offer ready-to-use turnkey platforms that can process an application, underwrite a loan, and deposit funds into the borrower's account, all within a few minutes.

One benefit of banks' lending to their own customers using new technology is that they can be faster than payday lenders, as they have a better knowledge and understanding of their borrowers through their pre-existing relationships.

3) Smaller Loans and Larger Loans Require Different Interest Rates

The pilot program had a targeted APR of 36 percent or lower, including all fees. This rate was tested to see whether banks would be profitable using it. For the larger loans in the pilot, which went up to $2,500 and carried an average term of 14 to 16 months, this rate can produce enough revenue so that banks can cover their costs. But small loans carry relatively fixed costs for origination, underwriting, technology, and fixed monthly costs for servicing. Having one rate for both relatively large small-dollar loans and relatively small ones means the larger loans produce far more revenue than the small ones, even though the costs of issuing the larger loans are only a little greater. At 36 percent APR, a $2,500, 16-month loan produces $684 in revenue, while a $500, 4-month loan produces $38. The former will tend to be sufficiently profitable that banks and other lenders will supply it; the latter has not been.

Perhaps unsurprisingly then, a hesitation to lend at rates higher than 36 percent has meant relatively few loans of just a few hundred dollars are issued by banks. And when banks ignored this 36 percent line, rather than price in the higher double digits that are likely necessary for standalone profitability, they leapt into deposit advance pricing with APRs in the 200s-300s. There is nothing I have seen in studying bank small-dollar lending that indicates three-digit APRs are necessary or appropriate. At the same time, the pricing targets used in the pilot worked for certain larger loans, but did not end up inducing banks to begin making very small loans widely available to customers most in need of an alternative to high-cost credit.

Sometimes providers have tried to cover these fixed costs by charging an application fee of say, $50, for all small-dollar loans. But such fees make very small loans expensive and effectively penalize borrowers who repay early. A $50 application fee is grossly disproportionate for a $200, 2-month loan. One key success of the pilot was steering the market away from using large upfront fees and instead focusing on a fee-inclusive cost of each loan.

4) Small Installment Loans Can Strengthen Bank-Customer Relationships

One of the foremost findings from the pilot was that small-dollar installment loans can deepen customers' ties to their banks. Most pilot banks reported small-loan offerings helped retain customers. Bankers also noted offering small loans can create goodwill in the community. Both customers and local groups appreciated banks offering small amounts of credit. The pilot suggested that offering small installment loans is likely to enhance banks' standing with both the community and their customers.

Because the pilot loans had similar default risk to other forms of unsecured credit, the large majority of customers who used the loans succeeded. Reporting these loans to credit bureaus is important so customers see their success reflected on their credit report, and so they are accountable if they do not repay. For customers who have mostly used nonbank lenders that do not report to credit bureaus, switching to bank-issued small-dollar credit could put them on a path of having a rising credit score so they can soon qualify for other products the bank offers. In this way, a small installment loan reported to credit bureaus can serve as a missing rung on a ladder to the financial mainstream.

Including a savings feature in small installment loans is another way to reduce credit risk and give borrowers better pricing as well as greater financial security. Some banks and credit unions offer borrowers the ability to make regular contributions to a savings account when repaying their loans. The savings accounts can build over time and help cover future emergency cash-shortfalls or serve as collateral, lowering the cost of borrowing.

5) Durations Should Be Tailored Based on Loan Sizes and Customers

Two weeks is not long enough for most customers to repay loans without taking another one. That is why most Deposit Advances were repeat loans to the same customers. Regulators and legislators have dealt with terms being too short in different ways. The FDIC pilot set a term of 90 days or more. The CFPB placed strong restrictions on loans that are due in 45 days or less because their research found such short loans tended to result in repeat borrowing. NCUA has required terms of at least one month. The OCC's May 2018 bulletin mirrored the CFPB's use of 45 days. Several banks and credit unions have set payments at 5 percent of each paycheck, as The Pew Charitable Trusts has recommended. This has the beneficial effect of creating shorter terms when loans are smaller or borrowers have higher incomes and can afford larger payments, or creating longer terms when loans are larger or borrowers have lower incomes and can afford smaller payments.

At the same time, a loan of just a few hundred dollars can accumulate substantial interest costs if repayments are spread out over an extended period of time. To try and limit excessive durations, NCUA originally set a maximum term of 6 months in its Payday Alternative Loan program, though it has more recently proposed extending that maximum to 12 months. The OCC's small-dollar loan bulletin suggested an outer limit of 12 months. The Pew Charitable Trusts has recommended a more flexible outer limit, where costs should never exceed half of principal. This has the effect of capping duration, with shorter terms for higher-rate loans, and longer maximum terms for lower-rate loans.

The detailed questions in this Request for Information certainly indicate the FDIC is taking this issue seriously, and I am delighted to see that. As you may know, The Pew Charitable Trusts published standards for bank small-dollar loans last year after extensive research of the market and numerous discussions with stakeholders. I contributed to some of Pew's early work on small dollar lending, and I would commend their research and recent published standards as important resources along with other commentary you will no doubt receive from consumer groups and industry sources.

While I will not go into the same level of detail as these other commentators, I would like to conclude with some high-level observations:

1) There is a need for more competition in this field, and banks are well-positioned to provide it via mobile and online banking. For banks to leverage their competitive advantages, they will almost certainly make heavy use of automation in processing applications, underwriting, and originating loans. If customers opt for automatic electronic payments, that should keep servicing costs down.

2) Installment loans are far superior to Deposit Advances, because they give consumers time to repay in installments. That lets consumers get their head above water, keeps payments more affordable, and lets them establish a track record with credit bureaus. Deposit Advances on the other hand— like payday loans —often create a cycle of high-cost debt.

3) Some back-end safeguards, such as a maximum term, a cap on total costs as a share of principal, or a minimum rate of amortization can ensure terms do not last too long and loans issued using a streamlined process do not get too large.

4) For short-term, small dollar loans, we have learned that flexibility on pricing is necessary. Larger, longer term loans have flourished using the 36% target rate contained in the FDIC guidance. Indeed, a maximum 36% rate has become the norm for most reputable bank and nonbank lenders in that market. However, rates above 36% may be necessary for loans of just a few hundred dollars to stimulate more competition, even though unnecessary for loans of a few thousand dollars.

5) Streamlined, low-cost underwriting is essential and consistent with prudential supervision for loans with such small balances. Banks and service providers should be able to make use of account history and alternative data rather than relying primarily on credit reports. Examiners should be empowered to accommodate underwriting flexibility.

Again, I commend and welcome the FDIC's continued interest under your leadership to enable banks to offer responsible small dollar credit products. While regulators must be vigilant in their oversight of small dollar lending, particularly given the vulnerability of borrowers in this market, competition can often be the most effective and direct way to drive down costs and give consumers more affordable choices when faced with unexpected financial needs.

Regards,

[redacted]

Sheila C. Bair