

January 18, 2019

Via E-Mail: Comments@fdic.gov

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Request for Information on Small-Dollar Lending (RIN 3064-ZA04)

Response of The Risk Management Association's Community Bank Council and Mid-Tier Bank Council

The Risk Management Association (RMA) appreciates this opportunity to respond to the FDIC's Request for Information on Small-Dollar Lending, published on November 20, 2018. RMA is a 501(c)(6) not-for-profit professional association whose sole purpose is to advance the use of sound risk management principles in the financial services industry. RMA helps its members use sound risk management principles to improve institutional performance and financial stability, and enhances the risk competency of individuals through, information, education, peer-sharing and networking. RMA has 2,500 institutional members that include banks of all sizes as well as nonbank financial institutions. They are represented in the Association by more than 18,000 risk management professionals who are chapter members in financial centers throughout North America, Europe, Asia, and Australia.

One of the most important components of RMA's mission is to provide independent analysis on matters pertaining to risk management and capital regulation. In this regard, the comments contained herein are informed by subject matter experts from member institutions of RMA's Community Bank Council and RMA's Mid-Tier Bank Council, but are not attributable to any single institution or group of institutions, some of whom may file their own comment letters. These comments and responses follow the format presented in the Request for Information, and each question is addressed separately below.

Consumer Demand

1. To what extent is there an unmet consumer demand for small-dollar credit products offered by banks?

Evidence suggests the existence of a substantial demand for small-dollar credit products; however, bank products currently are not being offered in a manner to satisfy consumer needs. Consumers resort to payday lenders to purchase school supplies, tools for a new job, and to cover auto repairs as a means to maintain their households during times of need. Customers need the opportunity to

access funds which they can repay in regular installments, as opposed to a lump sum, in order to provide reasonable alternatives to payday loans offered by finance companies.

Finance companies offering payday loans have grown significantly over the last several years. An industry which once was in decline seems to be growing again. For example, one such company was founded in 1987, focusing solely on consumer installment lending with a core portfolio of small and large personal loans. This company estimates there are approximately 80 million Americans that generally align with their customer base which they equate to a \$66 billion market opportunity. This evidences a significant demand for these types of consumer loans. The impact to this particular finance company is significant. As of September 2018, the company reported \$888 million in total receivables originated via multiple origination channels such as branches, direct mail, digital, referrals and retailers. The company's branch footprint more than tripled over the past 10 years and it now has a presence in 10 states. It has reported 14 consecutive quarters of double-digit receivable growth and nine consecutive quarters of double-digit revenue growth. This business is generated from a customer base that is not using the banking industry to serve their small loan needs. This company's loans range from \$500 to \$20,000, with an average of \$2,222, and have an Annual Percentage Rate ranging from 22.2% to 46.1%, and typical terms ranging from six to 60 months.

While the foregoing information pertains to only one finance company, it is important anecdotal evidence, as that company has sized the market opportunity as encompassing approximately 80 million consumers with a market size of \$66 billion, which would suggest that this demand for product is not adequately being met by banks.

2. To what extent do banks currently offer small-dollar credit products to meet consumer demand?

According to the OCC, U.S. consumers borrow nearly \$90 billion every year in short-term, small-dollar loans typically ranging from \$300 to \$5,000. Many banks have withdrawn from this market, resulting in consumers often turning to alternative lenders such as the finance company cited in the response to Question 1 above. (*See* OCC BULLETIN 2018-14, Core Lending Principles for Short-Term, Small-Dollar Installment Lending, May 23, 2018).

While certain banks continue to serve this underserved market, we note that they do so for established, rather than new customers, and typically do so through a credit card product. Offering small dollar loans requires alternative underwriting criteria as many of these borrowers may have negligible credit histories and low or nonexistent FICO scores. Determining underwriting criteria to be used in assessing ability to repay for the unique characteristics of these borrowers is very different than what is usually encountered in a community bank.

There appears to be no set way to underwrite these borrowers. As a result, banks need to be open to considering the use of alternative data to better understand their current and prospective customers and their ability to repay. This is a significant undertaking which requires expertise not readily found in many community banks. Furthermore, once these loans are closed, the collection

process needs to be structured and staffed to actively manage many calls on these small dollar loans.

3. To what extent and in what ways do entities outside the banking sector currently satisfy the consumer demand for small-dollar credit products?

The OCC has noted that entities outside of the banking sector currently satisfy consumer demand for small-dollar credit products. (See OCC BULLETIN 2018-14, which states that “Many banks have withdrawn from this market, resulting in consumers often turning to alternative lenders. Banks can provide affordable short-term, small-dollar installment lending options that can help consumers with their short-term financial needs while establishing a path to more mainstream financial products.”). Consumer finance companies have been growing over the past number of years as shown in the example in question #1. These companies have developed various origination channels, partnerships, and successful underwriting and collections strategies. One such company recently announced a partnership with a large credit card company to offer alternative payment solutions to merchants and consumers. This finance company’s plan is to join the credit card company’s large customer base with the finance company’s ability to offer point-of-sale financing options. The partnership would allow customers to finance large purchases without creating a large paper trail, making the interaction resemble a typical point-of-purchase sale.

4. What data, information, or other factors should the FDIC consider in assessing the consumer demand for small-dollar credit products?

The Consumer Financial Protection Bureau has compiled data that can possibly be instructive regarding the overall demand for small dollar loan products. This includes data supporting the Bureau’s June 2013 study of overdraft programs, as well as the extensive data and analysis the Bureau used in support of the issuance of its “Payday, Vehicle title, and Certain High-Cost Installment Loans” rule. Additionally, various policy institutes, advocacy groups, and nonprofit organizations have studied the market for small dollar loans and this work is publicly available. There is great demand for small-dollar credit products, but many community banks are not equipped to deal with the required expertise and resources to address this demand unless they can build a portfolio of sufficient size. The FDIC will need to consider the concentration risks presented by the need for volume in this type of lending. What level of risk is acceptable for a community bank to assume? Can the bank be compensated for that risk? And what types of partnerships can be created to mitigate the community bank’s risk while allowing it to provide these services to members of its community?

Benefits and Risks

5. What are the potential benefits and risks to banks associated with offering responsible, prudently underwritten small-dollar credit products?

Potential Benefits:

Sound small dollar lending would allow for the provision of products to bank customers that more closely match their short-term borrowing needs (e.g., term loan vs. line of credit). Affordable mainstream bank products could present reduced financial burden (lower rates) to customers relative to nonbank lenders. Additionally, banks would become more competitive with nonbanks for long-term customer relationships. A combined lending and deposit relationship would allow for sounder underwriting and payment programs (direct debit) than nonbank providers and would allow banks to better assist customers in improving their credit scores and transitioning them to better quality products. Overall, this type of lending would strengthen the relationship between banks and customers in need of such credit products.

Potential Risks:

These loans are typically unsecured in nature, and potential borrowers would likely present lower debt-to-income ratios and credit scores than typical bank borrowers. These products could present demands from new customers not possessing a historical banking relationship, presenting a greater challenge to risk analysis. Banks could see reductions in NSF fee income, as well as the risk of cancellation of employer automatic deposit arrangements. Administering these programs could require additional technology, reducing profit margins. Regulatory risk could arise concerning product structure and acceptability.

6. What are the potential benefits and risks to consumers associated with bank-offered small-dollar credit products?

Potential Benefits:

Consumers would be able to avoid overdraft fees and would have the convenience of “one-stop shopping” through bank offerings of products better suited to customer needs. Additionally, these loans could be offered under rate and fee structures that would be less costly than similar financing through nonbank lenders. In short, banks can meet consumers’ short-term, small-dollar credit needs by offering products with reasonable pricing and repayment structures. Moreover, banks can also provide consumers with other important financial services such as financial education and credit reporting.

Potential Risks:

These loans could represent a short-term solution for what could be a long-term cash flow problem.

7. What are the key ways that banks offering small-dollar loan products should manage or mitigate risks for banks and risks for consumers?

For Banks: Banks should manage or mitigate risks to banks by requiring direct deposit relationships for small dollar borrowers and providing small dollar loan offerings only to borrowers with whom they have a pre-existing customer relationship. Additionally, banks should

ensure that staff have the appropriate expertise to manage this type of portfolio, including proper analysis and pricing of risk. Also, banks should manage or mitigate the risk posed by these products by maintaining increased reserve levels for these types of loans.

For Consumers: Banks should manage or mitigate the risks posed to consumers by taking some or all of the following measures: (i) limiting the number of loans within a certain time period (example, per month, quarter, or year); (ii) limiting payments to a percentage of the consumer's paycheck or automatic deposit amount; (iii) establishing loan payments that ordinarily should not trigger overdraft or NSF fees; (iv) providing payment reminders and offering various payment options to align with cash flow; and, (v) offering lower rates for positive payment history and/or completion of a financial literacy course.

As part of the underwriting process, banks should assist loan applicants in preparing a monthly budget to ensure that sufficient funds exist to repay the loan.

8. What are the potential benefits and risks related to banks partnering with third parties to offer small-dollar credit?

Potential Benefits:

Partnering could provide additional fee income, reduce or eliminate burden on bank staff, provide potential additional product expertise, and expand the customer base outside of existing customers.

Potential Risks:

There are inherent risks associated with relying on a third party, including, reputation risk; operational risk posed by minimal oversight regarding the third party's day-to-day decision-making; the cost of the venture could exceed the income generated; regulatory risk, including fair lending and other regulatory issues if there are contradictions with the bank's typical consumer lending principles and processes; and, potential issues with CRA and/or the reasonably expected market area.

9. What steps could the FDIC take, consistent with its statutory authority, to encourage banks to develop and offer responsible, prudently underwritten small-dollar credit products?

The FDIC should re-affirm and appropriately update its "Affordable Small-Dollar Loan Guidelines" issued in 2007. The FDIC should make certain that supervisory expectations are clearly communicated to banks, particularly with regard to underwriting and credit analysis for these products. In addition, smaller banks that do not participate in this type of lending should not be penalized for either opting out of this type of product or limiting product offerings due to cost/benefit. Any inconsistencies in various state laws and regulations restricting or preventing the offering of such products must be addressed. Prudential regulators must ensure guidelines align with pertinent CFPB guidance, regulations and enforcement policy.

Challenges

10. Are there any legal, regulatory, or supervisory factors that prevent, restrict, discourage, or disincentivize banks from offering small-dollar credit products? If so, please explain.

Yes. Generally, a gap has existed between a bank's efforts to fulfill responsibilities under the Community Reinvestment Act and those regulatory expectations from a safety and soundness perspective as it relates to specific lending programs. While not impossible to overcome given prudent underwriting practices, banks' efforts have been further complicated by the supervisory focus on consumer protection as well.

In particular, the regulatory approach to fair lending monitoring seems to be focused on unsecured lending with a relatively low and/or unknown threshold which has been used to make referrals to the Department of Justice for possible pattern-or-practice claims. In conjunction with certain economic and competitive challenges, it is difficult to offer small-dollar credit products in a manner which will support additional compliance monitoring functions in addition to the day-to-day operations of this particular lending activity.

Additionally, there is some level of overall concern regarding supervisory expectations for small dollar lending. Various separate pieces of guidance that touch upon this type of lending have been issued by the prudential regulators, along with the "Payday, Vehicle Title, and Certain High-Cost Installment Loans" rule issued by the CFPB, have led to confusion and apprehension by banks regarding the acceptability of these programs from a supervisory standpoint. We believe it would be beneficial if the FDIC, the CFPB, and the other prudential regulators worked to align and coordinate guidance that helps clarify the current supervisory expectations for these types of programs. Clarity is particularly needed due to the Office of the Comptroller of the Currency's 2017 rescission of guidance related to deposit advance products, referencing in part as a basis the underwriting provisions contained the CFPB's payday loan rule. Similar guidance from the FDIC remains outstanding. Informal indications that consideration is now being given to removal of the underwriting provisions from the CFPB rule have further clouded banks' understanding of supervisory expectations with these products. We believe all-inclusive interagency guidance is needed with respect to small dollar lending, and such guidance should clarify how other outstanding guidance (deposit advance products, overdraft protection programs) aligns with this guidance.

The speed of technological advances and the increased expectations of the tech-savvy consumer have encouraged banks to leverage specialized technology providers for their expertise in building newer, customized products and services. Banks have also historically relied upon nonbank financial technology firms as key partners in providing core system and key product processing and support services.

All bank to nonbank partnerships are subject to third-party risk management guidance issued by the federal banking regulators, including FDIC FIL-44-2008. Being issued in 2008, this guidance does not address the types of providers and services that are now in place or in serious contemplation within our industry, particularly in the areas of due diligence and risk assessment procedures.

We believe the FDIC and the other federal banking regulators should, in coordination, review current third-party guidance through a notice and comment process with the goal of issuing joint guidance to gain consistency and remove added barriers to improving our processes and efficiencies in aligning with third party providers.

11. Are there any operational, economic, marketplace, or other factors that prevent, restrict, discourage, or disincentivize banks from offering small-dollar credit products? If so, please explain.

The costs associated with originating, administering, and monitoring a small-dollar credit program are typically significant relative to the earnings potential net of all costs associated with the program. Even if cost/benefit challenges could be overcome by volume, prudent diversification of risk within a community bank would serve to restrict the size of a small-dollar loan portfolio relative to the bank's capital base.

Assuming that the operational factors are non-existent, marketplace hurdles exist, created by competition from both non-depository lenders as well as credit unions. The convenience and familiarity offered by the non-depository lenders has created a significant barrier-to-entry for community banks despite what is typically a much higher cost of obtaining credit. Without a significant physical presence within the communities standing to benefit the most from a small-dollar credit program it is nearly impossible to transition those consumers from the non-depository lending institution to the community bank. Similarly, the increase in community-based lending from credit unions has proven to be a challenge to community banks particularly as it relates to small-dollar credit offerings. Given their generally more consumer oriented approach, credit unions are able to achieve certain synergies related to expenses associated with originating consumer credit without similar credit risk diversification and profitability goals typical to the community bank. The increase in community chartering activity among credit unions has only made this sector of lending more competitive and, thus, less attractive to the community bank.

12. What factors may discourage consumers from seeking responsible, prudently underwritten small-dollar credit products offered by banks?

Generally, convenience of delivery and familiarity with the non-depository or credit union lender seem to be the main factors which discourage consumers from seeking small-dollar credit products from community banks. These circumstances will prove difficult for the community bank to

overcome given regulatory oversight and there being no well-defined path to a delivery of small-dollar credit products that provides a reasonable risk-adjusted return of capital.

Product Features

13. Are there specific product features or characteristics of small-dollar loan products that are key to meeting the credit needs of consumers while maintaining prudent underwriting?

Small dollar borrowers are as unique in their needs as large dollar borrowers. The credit circumstances for each borrower are dynamic and ever-evolving depending upon the stability of the borrower's financial environment. Small dollar loans provide an important source of liquidity for households and may enable borrowers to make necessary purchases that they might otherwise not be able to make when critically necessary.

Therefore, the small dollar lending product choices that banks offer must be diverse enough to meet these various needs and wants and allow for the unique timing that are presented. Small dollar product choices must be available to borrowers via application processes that are online, mobile, and in-person. The product choices must include features that allow timely access, simplicity, and borrowing frequency to meet borrower needs. Each small dollar credit product must be affordable, provide clarity around the structure/benefits of the product and include technological security over borrowers' personal data.

Traditionally, banks have met the small dollar borrowing needs for their customers through secured and unsecured revolving credit cards, installment loans, overdraft protection services, direct deposit advances and other forms of single payment loans.

14. Are there specific product features or characteristics that are key to ensuring the economic viability to a bank of responsible, prudently underwritten small-dollar credit products?

The key characteristics that ensure economic viability to a bank in delivering small dollar credit products to the market are:

- Reasonable, simple, and understandable consumer disclosure requirements;
- Speed and efficiency in processing from application to payoff;
- Latitude to offer innovative product structures with pricing aligned to credit risk;
- Ability to apply unique underwriting criteria to ensure the ability to repay; and
- Effective servicing and collection process.

Innovation

15. How can technology improve the ability of banks to offer responsible, prudently underwritten small-dollar loan products in a sustainable and cost-effective manner? Please specify the technology or technologies and the use case(s).

Small dollar lending requires sufficient volume to overcome fixed-cost constraints, and the limited geographic footprint of most community banks would hinder their efforts to achieve an economically viable portfolio size. There generally is insufficient local demand for scale and profitability. Community banks can achieve this through Fintech partnerships that remove the barriers to the national reach.

A fintech partnership may be able to assist in the following ways:

- Provide a technology platform that can be used in various channels such as online, at merchant locations, and at bank offices.
- Provide a proven set of underwriting criteria that has been tested by portfolio analysis using charge-offs within homogeneous loan pools.
- Provide servicing and collections expertise.

16. Are there innovations that might enable banks to better assess the creditworthiness of potential small-dollar loan borrowers with limited or no credit records with a nationwide credit reporting agency?

The most innovative technology today is the use of artificial intelligence that analyzes spending and borrowing behaviors in a checking account. This data, coupled with local cost of living data, can predict borrowing needs of clients as well as ability to repay loans from predicted future cash flow. This entire process is automated with loan advance and paydowns made automatically without the need for underwriting.

17. What role should the FDIC play, if any, in supporting innovations that enhance banks' abilities to offer responsible, prudently underwritten small-dollar loans? Are there specific barriers that prevent banks from implementing such technologies or innovations?

The two most common barriers community banks face with this approach is CRA criticism and lack of expertise in understanding the algorithms used in the decision-making process. The CRA concern is present because community banks need a national reach (deposit gathering included) for a profitable program. Reforms to this regulation will allow more innovation to occur at community banks.

With regards to understanding the algorithms, there are opportunities for third party validation, but the FDIC must recognize that community banks will need to rely on those third parties. The FDIC

could treat these third party validators as critical to the system and perform a vendor analysis for banks to rely upon, such as is done for certain other bank vendors.

18. How can technology be leveraged to improve customers' experiences and reduce potential risks to consumers associated with small-dollar credit products?

The technology can virtually eliminate the biases in lending, because the decisions can be made without judgmental factors with regard to the borrower, other than the data. Technology can, through predictive behavior, also assist in reducing or eliminating the amount of debt that a borrower can assume.

Alternatives

19. What other products and services that supplement or complement small-dollar credit offerings should banks consider? Are there other ways that banks can help consumers address cash-flow imbalances, unexpected expenses, or income volatility besides small-dollar credit products?

Auto loans as well as bill pay services are obvious complements to small-dollar credit offerings that are not offered at payday loan sources. Overall, the best way a bank can help these consumers is by offering a product that is reasonable and ethical. This can be accomplished by addressing the following key issues that research has shown to be the biggest problems in this type of lending: (i) large monthly payments that consume a disproportionate amount of the borrower's paycheck; (ii) front-loaded fees that lead to refinancing, and (iii) non-competitive rates.

Other

20. Are there any distinguishing characteristics of particular institutions, such as a bank's size, complexity, or business model, that the FDIC should consider, and if so how?

The FDIC needs to consider a bank's size, its complexity, and/or business model. All or a combination of these three can determine if it is economically feasible for this product type to be offered. Considerations could be based on the bank's overall asset size or its retail to commercial customer ratio.

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In summary, RMA's Community Bank Council and Mid-Tier Bank Council believe there exists an unmet demand for consumer small-dollar loan products within insured financial institutions. However, challenges exist regarding the ability of smaller institutions to soundly and cost-effectively provide these services to those consumers most in need of such products.



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Should there be any questions concerning the comments reflected above, kindly contact Edward J. DeMarco, Jr., General Counsel and Chief Administrative Officer at 215-446-4052 or edemarco@rmahq.org.

Very truly yours,



Edward J. DeMarco, Jr.,
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