Currently, households in the United States that face cash flow shortfalls—that also are unable to run a balance on a credit card or borrow from a relative or friend—rely primarily on under-regulated entities (or “shadow banks”) to meet short-term borrowing needs. This post provides an overview of small-dollar loan (“SDL”) products available from these entities, concluding that these households would be better served by banks.

A surprisingly large share of the U.S. population is financially fragile and constrained in their ability to cope with unexpected events, such as a drop in income, loss of a job, or an emergency expense. For example, according to the 2018 Report on the Economic Well-Being of U.S. Households published by the Federal Reserve, about 40 percent of respondents to a recent, nationwide survey said they would have some difficulty coming up with $400 immediately. Further, about 60 percent of these households would cover the $400 expense by running a balance on their credit card or borrowing from a friend or a family member, while the remaining 40 percent would have to sell an asset, use a payday loan or simply not pay the unexpected expense.

Using an alternative framework, a recent study based on the National Financial Capability Survey defines financial fragility as the household’s ability to come up with $2,000 in a month if the need arose. Nearly one-third of survey respondents said they could not. Demonstrating a similar outcome, a recent study by the JPMorgan Chase Institute finds that about 65 percent of households lack sufficient liquid assets to overcome a typical income shortfall coupled with an expenditure spike. Overall, these measures indicate that a significant share of the U.S. population is highly vulnerable to financial stress.

The large share of households likely to struggle to cover an unexpected expense demonstrates the need for SDL products that meet short-term, small-dollar borrowing needs in a responsible manner. A considered and consistent approach from the CFPB and prudential banking agencies would help incentivize more banks to engage in this space.

To demonstrate how a responsible SDL would function, a comparison of underwriting requirements, as well as terms and conditions, to those of payday loans and other short-term, small-dollar consumer finance products available from non-bank lenders, is needed. In the following sections, we document the terms and conditions of non-bank provided small-dollar loans and their resulting harmful impacts on borrowers by reviewing relevant literature, and then highlight the differences relative to a responsible SDL product.

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4 Pew (2012) identifies five population groups among which payday borrowing is most concentrated: those without a four-year college degree; home renters; African Americans; lower-income households (earning less than $40,000 annually); and those who are separated or divorced. Other studies cited in a literature review by Guedj (2019) also indicate associations between these population characteristics and high cost, small-dollar borrowing.
CURRENT SMALL-DOLLAR LOAN PRODUCTS

**Payday loans.** As described by the CFPB (2013) and by Freeman and Gorham (2015), a payday loan is a small loan (usually no larger than $500) repaid in a single payment on the borrower’s next payday (typically a two week period) or on the next scheduled date for receipt of pension or Social Security income. For repayment purposes, the borrower submits a post-dated check for the full balance (including fees) or provides the lender with authorization to electronically debit the funds from a linked account or a prepaid card. A bounced check or overdraft fee may be charged if the debit (or post-dated check) does not clear.

Generally, a payday lender does not consider the customer’s ability to repay the loan while meeting other financial obligations (CFPB 2013).⁵ As described by Bennet (2019), payday lenders typically require that the customer have valid identification and proof of being 18 years or older, along with:

- A bank (or credit union) checking account or a prepaid card account; and
- Proof or verification of income from a job or other source (with direct deposit into the checking or prepaid card account).

Based on a review by the CFPB (2013), the terms and conditions shown in Table 1 characterize the typical payday loan. The fees charged average 15 percent of the loan amount, which results in an annual percentage rate (APR) exceeding 300 percent due to the short duration of the loan.

<table>
<thead>
<tr>
<th>APR</th>
<th>Loan Size</th>
<th>Duration (days)</th>
<th>Fees per $100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>Median</td>
<td>Mean</td>
<td>Median</td>
</tr>
<tr>
<td>339%</td>
<td>322%</td>
<td>$392</td>
<td>$350</td>
</tr>
</tbody>
</table>

A separate study by Pew (2012) further examines payday loan terms by distinguishing between (1) the 28 “permissive states” that allow fees ranging from $15 to $20 per $100 loaned; (2) the 14 “restrictive states” that either prohibit payday lending or impose rate caps “low enough to eliminate payday lending in the state” (often 36 percent); and (3) the remaining, moderately restrictive states. In “permissive” states, which consist of 55 percent of the U.S. population, the relevant results are shown in Table 2.

<table>
<thead>
<tr>
<th>APR Range (permissive states)</th>
<th>Mean fees per $100 (permissive states)</th>
<th>Mean loan size (all states)</th>
</tr>
</thead>
<tbody>
<tr>
<td>391 - 521%</td>
<td>$15 - 20</td>
<td>$375</td>
</tr>
</tbody>
</table>

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⁵ A payday lending rule proposed by the CFPB in 2016 included an ability-to-repay standard, but the agency has delayed implementation of this part of the rule and proposed dropping it from the rule.
Separately, the Center for Responsible Lending (2019) reports an even wider variation in average APRs across states that allow payday lending, ranging from 200 and 680 percent.6

Many payday loan borrowers engage in repeat borrowing multiple times in a year, generally through a renewal of the prior loan, which reflects the difficulty of repaying the entire amount borrowed plus a large fee within one month of incurring the original debt. According to the CFPB (2014), “over 80 percent of payday loans are rolled over or followed by another loan within 14 days.” The mean number of borrowings per year by an individual consumer is 10.7, and the median is 10, corresponding to mean and median accumulated fees of $574 and $458, respectively. Pew (2012) reports an average of 8 borrowings per year by an individual consumer, corresponding to $528 in accumulated fees. Thus, accumulated fees through renewed borrowings often substantially exceed the initial amount borrowed.

**Auto title loans.** Another form of non-bank SDLs includes auto title loans. As described by Davis et al. (2013) and Pew (2015), auto title loans are underwritten primarily based on the value of the collateral, with an amount based on a portion of the value of the underlying vehicle.

Generally, the customer can have no other loans outstanding that are collateralized by the same car. As with payday loans, the customer’s ability to repay the loan while meeting other financial obligations is generally not considered. In contrast to payday loans, these borrowers are not required to have a bank account or a credit check run, and certain lenders do not require proof of income or employment.

An auto title loan typically has a duration of one month, with the loan principal plus a fee repaid in a single balloon payment.7 Typical terms applicable to auto title loans, based on Davis et al. (2013) and Pew (2015), are shown in Table 3.8

<table>
<thead>
<tr>
<th>Mean APR</th>
<th>Mean Loan Size</th>
<th>Average fees per $100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Davis et al.</td>
<td>Pew</td>
<td>Davis et al.</td>
</tr>
<tr>
<td>300%</td>
<td>300%</td>
<td>$951</td>
</tr>
</tbody>
</table>

At the time of repayment, the borrower can either repay the amount borrowed plus fee or interest, or the borrower can renew the loan, paying only the fee or interest due. Like paydayloans, most auto title loans are renewals, rather than new extensions of credit. According to Davis et al. (2013), “the average car-title borrower renews their loan eight times, paying $2,142 in interest for $951 in credit.” Using state regulatory data, Pew (2015) determines that renewals constitute about 84 percent of all title loans in Tennessee and about 63 percent in Texas. Thus, accumulated fees through renewed borrowings substantially exceed the initial amount borrowed.

6 Oregon is an exception, with average APR of 150 percent. Five states: Idaho, Nevada, Ohio, Texas, and Utah, are reported to have average APRs greater than 650 percent.

7 The lender holds the title and duplicate keys while the loan is outstanding, and the customer retains use of the car.

8 As in the case of payday loans, limits on loan sizes, fees, and durations vary across states, resulting in large cross-state variation in the costs for borrowers of auto title loans.
Further, an auto title lender may repossess the car of a borrower whose loan is past due, in order to sell it and recover the amount owed. According to Pew (2015), between 5 and 9 percent of borrowers lose their cars to repossession annually; of these, 15 to 25 percent of repossessed vehicles are returned to borrowers who pay their overdue loan balances plus fees.9

**Non-bank small-dollar installment loans.** Installment loans offered by consumer finance companies are another option for borrowers who might not qualify for credit cards or personal loans from banks.10 In this context, lenders conduct some assessment of a borrower’s ability to pay. Here, according to Pew (2018), lenders will pull a credit report, request a pay stub, and “analyze monthly payments on major credit obligations and some self-reported recurring expenses.”

The loans are repaid in monthly installments over varying contractual repayment periods.11 The borrowing costs on these loans are comparatively affordable. Specifically, for approximately 85 percent of loans, monthly payments do not exceed 5 percent of the borrower’s monthly income, per Pew (2018).12 However, Pew (2018) finds two major weaknesses “that obscure the true cost of borrowing and put customers at financial risk.”

First, the true APR (which averages 90 percent for loans less than $1,500) is usually higher than the disclosed APR, because borrowers usually purchase ancillary credit insurance and this premium is not incorporated into the disclosed APR.13 Pew (2018) also finds that credit insurance (while not required) frequently is included in the loan contracts by default and, in states where the sale of credit insurance is allowed, almost 80 percent of contracts had at least one type of insurance.14 The study argues that “customers pay far more than they benefit from the coverage, as indicated by credit insurers’ extremely low loss ratios—the share of premium dollars paid out as benefits,” which are “considerably lower than those in other insurance markets.”

Second, the study finds that borrowers frequently refinance these loans, which “prolongs indebtedness and substantially increases the cost of borrowing, especially when origination or other upfront fees are reapplied.” Lenders often use persuasive marketing to encourage borrowers to refinance prior to the expiration of the original loan, and early refinancing increases the cost of borrowing because of the frontloading of fees and interest charges.

**ADDITIONAL CONSIDERATIONS: DISCLOSURE, TRANSPARENCY AND CREDIT REPORTING**

The ultimate borrowing cost associated with nonbank, small-dollar credit products often may not be fully transparent to many consumers, in that they often may not anticipate fee accumulation via a rollover. Further, the true APR may not be transparent to consumers because of the omission of credit insurance premiums from the disclosed APR. For

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9 Davis et al. (2013) find that “one in six borrowers in our data set faced repossession, with repossession fees averaging half of the borrower’s outstanding loan balance.”

10 Like payday lenders, consumer finance companies are subject to state regulations that may set limits on loan sizes, interest rates, fees, or other loan terms.

11 The repayment period averages 11 months for loan amounts of $1,500 or less, per Pew (2018).

12 According to Pew (2018), “previous research shows that monthly payments of this size [on an amortizing loan] fit into typical borrowers’ budgets and create a pathway out of debt” (p. 1).

13 The average “all-in” APR of 90 percent compares to an average stated APR of 70 percent for loans less than $1,500, for which the average loan size is $742, according to Pew (2018). The Truth in Lending Act does not require the cost of credit insurance to be incorporated into the disclosed APR.

14 As described in the study, “focus groups reported that credit insurance products were automatically added to their loan contracts with an opportunity to opt out, rather than offered before the papers were drawn up. These qualitative findings are consistent with previous research showing that insurance is frequently a standard component of loan contracts.”
auto title loans, consumers may not be aware of the sizable fees that would be charged in the event of repossession due to default.

Studies demonstrate that payday and other similar non-bank products do not provide the requisite feature and cost transparency to potential borrowers, possibly harming the borrower’s ability to make a fully informed decision about the product and how it may impact his/her economic well-being.\textsuperscript{15} Other studies suggest that borrowers might choose alternatives to payday products if presented with more transparent products that permit them to make more effective decisions in a way that contributes to their overall financial health.

An additional point relates to credit reporting. Since payday and auto title lenders do not rely on credit reports, potentially favorable information about borrowers, such as on-time repayments or better financial choices would not be relayed to future creditors, thereby potentially limiting the ability of certain borrowers to receive other opportunities or other forms of credit.

**OPENING UP THE CHOICES FOR SDL BORROWERS**

To alleviate the concerns with non-bank provided SDL products, a responsible SDL would align with the following terms and conditions, with a basic framework in mind—to provide short-term liquidity in a low-cost and transparent manner.

**Underwriting and affordability.** Monthly payments should not pose affordability challenges for the borrower, and the terms and costs of borrowing should be transparent and well understood. Further, a goal should be to limit instances of the borrower ultimately paying more than double the initial amount borrowed. The loan should provide a reasonable return to the lender and not expose the lender to excessive risk of borrower default.

Toward these goals, a bank providing these products could assess to some degree a borrower's ability-to-repay when evaluating whether a prospective borrower qualifies for the SDL. To do so, the bank could consider whether the borrower established a checking account at the institution, with some minimum period of observed activity, as well as the transaction history of the account, which would be reviewed for indications of adequate liquidity and stability of cash flow.

**No rollover.** A responsible SDL should facilitate repayment according to an agreed-upon schedule in line with the borrower’s own monthly budgeting. It should not potentially “trap” the borrower into a series of rollovers or refinancing leading to higher than anticipated costs.

Toward this objective, restrictions on extending the originally scheduled repayment period of an SDL, whether an installment loan or line of credit, via rollover or refinancing could be provided. Ruling out rollovers incentivizes borrowers to manage their budgets toward the goal of repaying on schedule and incentivizes appropriate underwriting.

**Repayment schedule.** The choice of an appropriate term-to-maturity of a small-dollar installment loan (or length of the repayment period for a small-dollar credit line once the draw period has expired) involves a tradeoff. Holding the loan size constant, a smaller monthly payment is more affordable for the borrower, but the resulting slower paydown exposes the borrower to the risk of default on the debt due to a change in situational circumstances.

\textsuperscript{15} See, for example, Lusardi and de Bassa Scheresberg (2013). Similarly, Zinman and Carrell (2014) study effects of payday loan access on Air Force personnel and find that "job performance and retention decline with payday loan access, and severely poor readiness increases," especially among less financially sophisticated personnel. On the more general question of whether payday lending on the net is beneficial to consumers, the academic literature yields mixed conclusions. See Freeman and Gorham (2015) and Trilling (2016) for literature reviews addressing this question.
Indeed, U.S. Bank already provides a small-dollar product, and the APR of a $400 loan with a 3-month term is 35.65%. See https://www.usbank.com/loans-credit-lines/personal-loans-and-lines-of-credit/simple-loan.html

To mitigate the latter risk, the lender should choose the minimum term consistent with keeping the loan reasonably affordable.

**Disclosure and transparency.** Origination and other fees would be fully transparent. Borrowing costs would be disclosed in a manner ensuring they are fully anticipated and understood. For example, there could be a limit on ancillary fees, such as prepayment penalties or late fees.

**APR.** Underwriting of a responsible SDL will necessitate enhanced efforts to assess a borrower’s capacity to repay, which entails corresponding costs. However, we expect that banks are capable of offering SDLs at a comparable or lower cost than non-banks, due to lower overhead expenses associated with having branches that provide a variety of banking services.

As noted above, “all-in” APRs for small (less than $1,500) loans from consumer finance companies average 90 percent, although this does not incorporate the additional return generated in many cases through early refinancing.\(^{16}\)

It is reasonable to expect that there will be variation across individual banks in the costs associated with providing responsibly underwritten SDLs that fit the borrowing needs and risk profiles of their customers, and therefore in the APR and other terms banks offer, but a responsible SDL would likely be more affordable than loans offered by non-banks.\(^{17}\)

**Credit reporting.** To the extent a bank did so, reporting payments and non-payments to credit reporting agencies on a consistent basis would allow borrowers who rely on small-dollar loans (who generally have weak or thin credit histories, or none at all) the potential to build—or rebuild—a favorable credit record. Reporting of timely repayments would also provide borrowers with added incentive to comply with the agreed-upon repayment schedule.

**CONCLUSION**

Our literature review finds that the small-dollar credit products provided by non-banks have very elevated APRs and are underwritten with minimal consideration to the borrower’s ability-to-repay. Generally, there is a lack of disclosure or transparency regarding the likely, ultimate all-in costs to the borrower of such loans. The repayment of such loans is often not affordable, thereby necessitating the rollover of the loan. Successful repayment typically is not reported to the credit bureaus.

Given the large share of households that are likely to struggle to cover a small and unexpected expense, there is a need for an SDL product that would meet their short-term, small borrowing needs in a responsible manner. We have highlighted considerations for the design of a responsible SDL that would provide temporary liquidity at relatively low cost, with transparent terms that are fully understood by the borrower.

Allowing more banks to offer responsible SDL products would improve the welfare of U.S. households that struggle to pay small and unexpected expenses. A supportive and coordinated approach from the CFPB and the other prudential banking agencies to minimize the regulatory risks for banks that offer small-dollar products would assist in furthering more choices for borrowers in this space.

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\(^{16}\) In avoiding the early refinance practices deemed non-transparent and harmful to consumers, a responsible SDL likely would result in lower revenue than that received with nonbank installment loans.

\(^{17}\) Indeed, U.S. Bank already provides a small-dollar product, and the APR of a $400 loan with a 3-month term is 35.65%. See https://www.usbank.com/loans-credit-lines/personal-loans-and-lines-of-credit/simple-loan.html
REFERENCES


