Costs and Pricing of Bank-Provided Small Dollar Loans

12.15.20

Paul Calem

202.997.0867

Paul.Calem@bpi.com

Last month, Bank of America introduced a small dollar, short-term installment loan product called "Balance Assist" that allows customers to borrow up to $500 to be paid back in three equal monthly installments. In doing so, Bank of America joined several other large banks that offer small dollar borrowing options to households facing a temporary cash shortfall. For example, U.S. Bank offers a product called "Simple Loan" with a three-month repayment term, portrayed as "a quick and convenient way for U.S. Bank checking customers to borrow up to $1,000 to take care of planned and unplanned expenses." Fifth Third Bank, KeyBank and Regions Bank also offer small dollar credit products.[1]

These products display the hallmarks of a "responsible" small dollar loan as outlined in recent communications from the federal regulatory agencies.[2] For instance, they feature simple and transparent terms; eligibility requirements designed to keep delinquency rates low; and restrictions on the rollover of the loan.[3] The cost to a borrower for any of these loans is far lower than a payday loan from a nonbank, although a range of average percentage rates is observed both within and across these small dollar programs.

In this research note, I examine the reasons for the varying APRs of bank-provided, responsible small dollar loans, which in part are tied to the costs to a bank of offering such a product. These include costs associated with developing and maintaining an online lending platform along with program administrative costs, which can be quite material on a per-dollar basis. The repayment risk of small dollar loans also tends to be relatively high, implying relatively high costs from administering workout strategies or alternative repayment schedules for delinquent borrowers, or from higher loss rates.

The pricing of small dollar loans reflects not only these cost factors, but also potential ancillary benefits to the bank offering small dollar loans, including potential long-term benefits through strengthened customer relationships. Naturally, the pricing of small dollar lending programs will vary across banks depending on the borrower eligibility criteria applied and the various other cost and benefit considerations.

Since small dollar loans have short maturities, origination, administrative and default costs often translate into relatively high costs on an annualized, per dollar basis. Moreover, the pricing of small dollar products typically incorporates a flat fee. Therefore, the associated APR will vary

[1] Fifth Third Bank and KeyBank offer small dollar credit lines featuring credit limits as low as $200 (Fifth Third's EarlyAccess product) and $250 (KeyBank's KeyBasic credit line).

[2] The installment loan products also are consistent with analysis and recommendations from the research-based advocacy organization Pew Charitable Trusts.

[3] Since lines of credit have no specified payoff date, the concept of rollover does not apply to them. However, the minimum required payments on the Regions and KeyBank small dollar credit lines are relatively high (for instance, in comparison to the typical credit card), thus promoting quicker repayment and sound debt management, as with prohibiting rollover.

across individual borrowers depending on the size of the loan and the length of the selected repayment term, and could also vary widely across banks. The fact that the APR is highly responsive to loan size and term limits its utility as a measure of borrowing costs in the small dollar context.

I proceed by first reviewing the recent regulatory statements on the characteristics of a responsible small dollar loan program. I then go on to examine in detail the cost and other factors that determine the pricing of bank-provided, responsible small dollar loans. Lastly, I highlight the limitations of the APR as a measure of the borrower's cost of credit in this context.

Recent Regulatory Developments

In light of recent studies indicating that a large share of the U.S. population is financially fragile, there is increasing recognition of how responsible small dollar loan products such as those introduced by several banks help consumers who face unexpected cash shortfalls like those resulting from the COVID-19 pandemic.[4] This recognition is reflected in policy statements issued by the federal regulatory agencies.

On May 20, the Federal Reserve, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and National Credit Union Administration issued an interagency statement offering principles for designing responsible small dollar lending programs that "facilitate a customer's ability to demonstrate positive credit behavior and transition into additional financial products." In particular, the statement describes principles that would be reflected in "affordability, eligibility, and appropriate underwriting" and in "repayment terms, pricing, and safeguards that minimize adverse customer outcomes, including cycles of debt due to rollovers or reborrowing."

On May 22, the Consumer Financial Protection Bureau approved a No-Action Letter Template that had been submitted by the Bank Policy Institute.[5] The No-Action Letter establishes operating guardrails for a depository institution to offer responsible small dollar credit products for amounts of up to $2,500. These guardrails, which are designed to protect borrowers, include considerations for simple and transparent terms and conditions and parameters for repayment terms and underwriting requirements.[6] On Nov. 5, the CFPB announced that it had approved a no-action letter application from Bank of America, which thus became the first major bank to be granted no-action relief for its small dollar program.

Banks' Costs of Offering Small Dollar Loans

There is a lack of hard data on the costs of bank-provided small dollar loans or lines of credit. Nevertheless, informed reasoning indicates that the annualized per-dollar cost for a responsible small dollar loan will be significantly higher than for most other types of consumer loans.

[4] For instance, according to the Board of Governors of the Federal Reserve System (May 2020), 37 percent of households would have some difficulty coming up with $400 immediately.

[5] A No-Action Letter from the CFPB is issued under the agency's NAL Policy. An NAL "provides increased regulatory certainty that the Bureau will not bring a supervisory or enforcement action against a company for providing a product or service under certain facts and circumstances." The Bureau approved the NAL Template "to further competition in the small-dollar lending space, which fosters access to credit while including important protections for consumers who seek small-dollar loan products."

[6] BPI published a research note in May 2020 that explains the terms and conditions of a responsible small dollar credit product, which are essentially those delineated in the No-Action Letter Template.

Each application for a small dollar loan entails an incremental cost to the bank and the borrower. In particular, the bank must verify that applicants meet program eligibility requirements, which may include undergoing a credit check. Depending upon the nature of the verification, these costs can vary. For example, a fully automated verification that the applicant meets a credit score threshold and has a checking account in good standing with the bank is apt to be less costly than manual review of a full credit report.

Moreover, any such program is apt to require substantial overhead costs. As emphasized by Woosley (2020): "As with any new product, introducing small-dollar loans would add operational complexity and increase operational risk. The lender would need new or revised policies and procedures to govern the product. Depending on current system capabilities, a new or enhanced system may be required to process and service the loans."

In particular, developing an online application and origination platform for a small dollar lending program, including the infrastructure to link the loan and checking account of the borrower, entails costs. Even if spread out or amortized over multiple years of a development cycle, the costs can be relatively high per loan dollars originated.

Ongoing expenses of maintaining an online platform would add to these per dollar costs. These include the cost of ensuring appropriate cybersecurity protections and as noted by Woosley (2020), the cost of mitigating risks of system errors or failures.

In addition, a small dollar loan program entails marketing and general administrative expenses. The latter category includes costs of program management, legal and regulatory compliance, consumer complaint monitoring and auditing.

Any of these cost components could vary across individual banks, depending on specific aspects of a bank's small dollar program and how readily it fits into banks' existing technological infrastructure and administrative processes. Conceivably, a bank with a larger program may be able to spread overhead costs across a larger number of borrowers, allowing for lower fees.

COSTS ASSOCIATED WITH MISSED PAYMENTS OR DEFAULT

The risk that a small dollar borrower will be unable to repay on schedule may be relatively high compared with other types of consumer credit from banks. The typical small dollar borrower lacks access to alternative sources of credit, such as obtaining a line increase on an existing credit card or acquiring a new card, because he or she has a low credit score or is not scoreable due to a sparse credit history. Also, borrowers often face a significant cash flow imbalance at the outset.

Durkin, Elliehausen and Hwang (2014) discuss findings from a survey conducted by the American Financial Services Association of their member companies on the characteristics of consumer installment loans outstanding as of the end of December 2013. Their discussion focuses on the subsample of 3.1 million of these loans originated within six months prior to that date. The loans mostly fit the profile of a small dollar program: almost 80 percent of them were for amounts of $2,000 or less and almost 60 percent had terms of one year or less. Among loans for which a credit score was reported (a majority of the sample), about 88 percent had scores in the subprime range, many of which were deep subprime.

Durkin, Elliehausen and Hwang [see above] report that nearly one quarter of the loans in the AFSA subsample they analyzed were in some state of delinquency on the survey date (Dec. 31, 2013), with higher delinquency rates among smaller loans and loans to borrowers with lower credit scores.[7] These elevated delinquency rates reflect the risk factors inherent in the borrower population, as the loans in the sample do not have "predatory" features: their APRs are much lower than those of payday or auto title loans and they are associated with monthly payments typically considered affordable.[8]

The FinTech company LendingClub regularly publishes data on the repayment performance of its consumer installment loans, although these are not small dollar loans. For installment loans with a 36-month term to maturity originated in 2015 in the two highest risk categories (rating grades F and G), Lending Club reported cumulative charge-off rates of about 14 percent within the first 12 months after origination and 21 percent within 18 months. In the next lowest rating grade (grade E) for 36-month loans originated that year, LendingClub reported an 8 percent cumulative charge-off rate within the first 12 months and 14 percent within 18 months.

Banks with responsible small dollar programs will act to mitigate this risk by screening applicants for small dollar credit based on credit report information, cash flow assessment using checking account information or other indicators. Banks offering these loans to customers with existing checking account relationships would have more such information available for mitigating this risk. For instance, according to Ennis (2020), small dollar borrowers at U.S. Bank "must be U.S. Bank customers, and they're assessed based on cash flow, income and credit profile details," and because of this, risk is lower.

In addition to effective credit screening, a hallmark of a responsible small dollar installment loan or line-of-credit program is that lenders generally will seek to offer a workout strategy or alternative repayment schedule for delinquent borrowers.[9] Such personalized attention to a delinquent borrower requires a commitment of employee time and other administrative costs. If the workout strategy is not feasible or not successful, the unpaid balance becomes a charge-off that is unlikely to be recovered. In the case of small dollar loans, such costs are likely to amount to a substantial percentage of the loan balance.

Banks can mitigate repayment risk for their small dollar programs but cannot eliminate it, and the vulnerable financial situations of many small dollar borrowers create special challenges. The statistics cited above suggest that a 10 percent overall cost of delinquency management and charge-off is well

[7] More than 38 percent of the smallest loans were delinquent on the survey date, but only about 12 percent of the largest loans.

[8] About 40 percent of loans in the sample have an APR less than or equal to 40 percent, and half of the loans have and APR in the 49 to 99 percent range. According to the Pew Charitable Trusts (2018), installment credit products from consumer finance companies typically have monthly payments no greater than 5 percent of the borrower's monthly income, which makes them an affordable alternative for those who cannot qualify for credit cards or for personal loans from banks.

[9] The interagency statement on principles for responsible small dollar lending emphasizes "processes that assist customers in achieving successful repayment while avoiding continuous cycles of debt and significant credit costs due to rollover or reborrowing. For customers who experience distress or unexpected circumstances affecting their ability to repay small-dollar loans, such processes may include timely and reasonable workout strategies." In contrast, a common criticism of payday loans is that in the event that a borrower is unable to repay on schedule, these loans frequently are rolled over, which leads to accumulating fees and potentially trapping the borrower in a cycle of debt.

within the range of possibility for a responsible, small dollar loan program, even for loans with terms as short as three months.[10]

Banks will vary in their appetite for risk—the degree to which they will be willing to take on greater repayment risk to allow more borrowers to qualify for credit. Those that take on more risk in general will face higher costs associated with missed payments and defaults.

How Banks' Costs Affect APRs (An Illustrative APR Calculation)

In general, a bank would expect to be compensated for the costs of providing small dollar loans through the interest or fees collected from borrowers. Given the cost considerations outlined above, it is now easy to see how the requisite APR for a small dollar loan may be substantially higher than the APRs commonly associated with banks' more standard consumer credit products.

For example, consider the case of a $500 loan to be repaid over three months. Reasonably, it may cost the bank $25 per loan toward overhead, program maintenance and administrative expenses and, on average, 10 percent of the loan amount ($50) for workout strategies and loan losses. The cost of the loan to the bank is then 15 percent of the loan amount. Multiplying by four puts the annualized cost of the three-month loan at 60 percent. Thus, an APR of 60 percent is required to cover the cost of the loan (over and above the bank's funding cost).

As this example shows, the fixed cost of originating a loan implies a substantial per-dollar cost for small loans. When these loans also have relatively short repayment periods, annualizing this cost combined with the costs associated with repayment risk can imply a high APR for the loan.[11] If banks are subject to an interest rate cap that does not allow recovery of the costs of making small dollar loans, then banks will be unable to originate such loans.

Consistent with this reasoning, Durkin, Elliehausen and Hwang find that APRs in the survey subsample they examine are go up when loan size, the length of the loan term or the borrower's credit score go down. They also find that in states that impose rate caps, far fewer consumer installments originated, and the loans that are originated are substantially larger and have longer repayment terms.

Ancillary Benefits to a Bank and Other Pricing Considerations

Cost factors are not necessarily the only considerations for the pricing of a small dollar loan program. A bank might expect long-term benefits from offering small dollar loans. The small dollar program could help customers transition to a more stable financial situation, to a longer-term relationship with the bank and to utilizing other bank products. Moreover, helping customers meet short-term liquidity needs by offering affordable alternatives to payday loans may positively reflect on a bank's reputation. Such

[10] Although longer repayment terms increase the risk that a borrower will experience a financial setback prior to repaying the loan, short repayment terms are more apt to be associated with borrowers under greater financial duress at the time they receive the loan.

[11] Note that an additional cost to the bank of providing small dollar credit is that of funding the loans (although in the current interest rate environment, with short term interest rates near zero, this cost is small). Another is the cost of allocating capital to the small dollar loan portfolio, which is subject to the same regulatory capital requirements as other consumer installment loans or lines of credit.

benefits would offset a portion of the costs and translate into a lower price (interest rate or fee) for the loans.

For instance, U.S. Bank has indicated that a small dollar program creates "opportunities to enhance customer relationships," as reported in Bhattacharyya (2020). The same article notes that in the view of industry analysts, offering small dollar loans could help customers build trust and help them boost their credit scores by making on-time payments, thereby encouraging and qualifying them to take up other products over time.

Similarly, the Financial Health Network (2020) sees offering a small dollar loan program as an investment in consumer financial health that leads to greater profitability and higher customer loyalty and retention. Consistent with this view, Bank of America sees its small dollar program as a way to keep their customers from having to rely on higher cost alternatives outside of "mainstream banking," according to Ennis (2020).

As with the cost factors, the pricing implications of these potential benefits may vary across banks and with market conditions. The ancillary benefits will depend on a particular bank's retail product mix, business strategy and customer profiles. For example, a bank with a long-run focus on credit card lending may see benefit from nurturing relationships that are likely to result in new credit card customers.

A final consideration is that a bank that links its small dollar loan program to a particular checking account product may view these as a package and price them as such. Some of the cost of the small dollar program might then be allocated to the checking account product, allowing for a lower fee for the small dollar product. Whether a bank chooses to package the products as such would depend on its business strategy and the perceived needs of its customers.[12]

Limitations of the APR for Quantifying the Borrower's Cost of Credit

It is important to bear in mind that while the APR is a useful construct for helping consumers comparison shop for credit, it does not capture all important factors relevant to evaluating the consumer's cost of credit. In particular, the APR of a small dollar loan scheduled to be repaid in a few months is not directly comparable to the APR of a loan of the same size that extends over 12 months or more—the short-term loan may have a higher stated APR but be associated with smaller accrued out-of-pocket cost to the borrower.

For example, a loan that is repaid in three months for which the borrower is charged a fee equal to 18 percent of the amount borrowed will have an APR of about 72 percent. However, this loan clearly costs the borrower far less in interest and fees than a 12-month installment loan with a 36 percent annual interest rate (or a three-month loan that is rolled over four times), for which the borrower pays cumulative interest equal to 36 percent of the amount borrowed. The better option for the borrower depends on how important it is to the borrower to extend the repayment period versus the cumulative out-of-pocket cost.

[12] Such a pricing structure may be rationalized on the basis that ready access to a small dollar loan is a potential benefit to all checking account customers, as a form of insurance against temporary liquidity shortfalls.

A responsible small dollar loan must be affordable and have a reasonable likelihood of repayment.[13] Affordability depends not only on pricing but also on appropriate underwriting and structure. To make small dollar loans affordable, lenders have to offer loans with a small size and a shorter term. However, these two features will boost the APR. In addition, efforts by lenders to screen borrowers prior to origination and to work with delinquent borrowers to resolve emerging repayment problems – which help make these loans affordable – impose additional costs that can further boost the APR of small dollar loans.

Lastly, note that important cost tradeoffs make it difficult to reduce an APR by holding fees constant while modifying other loan terms. For example, extending the borrowing term to 12 months (obviating the need to multiply by four to obtain an annualized cost) or offering the borrower a larger loan (thereby lowering the percentage origination cost) would not necessarily reduce the required APR, since a lengthened term or larger loan size would increase the expected cost of default.

Concluding Remarks

The costs of developing, maintaining and administering a small dollar loan program are material, particularly on a per-dollar basis. Offering small dollar loans may also entail relatively high repayment risk, since borrowers' cash shortfalls (their reason for borrowing to begin with) may persist through the end of the loan term. Because of these distinguishing characteristics, it is reasonable to expect that the APRs for small dollar loans often may exceed those generally observed for other types of consumer credit provided by banks.

As more banks join the roster of those with responsible small dollar lending programs, it is to be expected that the structure and pricing of the programs will vary across banks. Pricing will reflect these cost factors as well as potential ancillary benefits to the bank of offering small dollar loans. These determinants of pricing will vary with banks' individual circumstances, their business strategies and the degree to which they will be willing to take on greater repayment risk to allow more borrowers to qualify for credit.

While the APR is a useful construct for helping consumers comparison shop for credit, it does not capture all important factors relevant to evaluating the consumer's cost of credit. This is especially so in regard to short-term, small dollar loans for which fees will seem relatively large when represented on an annualized, per-dollar basis.

[13] The discussion in this paragraph draws on ideas put forth in Center for Financial Services Innovation (2014), especially the discussion pages 6 and 7 therein.

References

Bhattacharyya, Sumain (October 2020), "With stimulus in legislative limbo, market may see boost in small-dollar loans." https://www.bankingdive.com/news/small-dollar-loans-stimulus/586215/

Ennis, Dan (October 2020), "Bank of America Enters the Small Dollar Loan Fray." https://www.bankingdive.com/news/bank-of-america-enters-the-small-dollar-loan-fray/586754/

Board of Governors of the Federal Reserve System (May 2020), "Report on the Economic Well-Being of U.S. Households in 2019, Featuring Supplemental Data from April 2020." https://www.federalreserve.gov/publications/files/2019-report-economic-well-being-us-households-202005.pdf

Center for Financial Services Innovation (2014). *The COMPASS Guide to Small Dollar Credit*. https://s3.amazonaws.com/cfsi-innovation-files/wp-content/uploads/2017/02/27224444/CFSI_Compass_GuideToSDC.pdf

Durkin, Thomas A., Gregory Elliehausen, and Min Hwang (2014), "Rate Ceilings and the Distribution of Small Dollar Loans from Consumer Finance Companies: Results of a New Survey of Small Dollar Cash Lenders." https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2533143

Financial Health Network (2020), "How Financial Institutions Can Structure Small-Dollar Credit for Financial Health." https://s3.amazonaws.com/cfsi-innovation-files-2018/wp-content/uploads/2020/09/03154903/SDC-brief-Final.pdf

Pew Charitable Trusts (October 2018). "State Laws Put Installment Loan Borrowers at Risk – How Outdated Policies Discourage Safer Lending." https://www.pewtrusts.org/-/media/assets/2018/10/installment-loans_report.pdf

Woosley, Lynn (July 2020), "Is It Time for Banks to Resume Small Dollar Lending?" https://www.treliant.com/knowledge-center/is-it-time-for-banks-to-resume-small-dollar-lending/