Regulatory Risks May Discourage Small-Dollar Lending by Banks

Paul Calem | Sept. 12, 2022

Many U.S. households lack the financial resources needed to meet small, unexpected expenses, making them vulnerable to episodes of financial stress. When faced with cash shortfalls, these households typically rely on payday loans or other high-cost, nonbank credit products as their most readily available option.

For example, according to the 2022 Report on the Economic Well-Being of U.S. Households published by the Federal Reserve, about 32 percent of respondents to a recent, nationwide survey said they would have some difficulty coming up with $400 immediately (using cash, savings or a credit card paid off at the next statement.) About 70 percent of these households would cover the $400 expense at least in part by running a balance on their credit card or borrowing from a friend or a family member, while the remaining 30 percent would have to sell an asset, use a payday loan or simply not pay the unexpected expense.

Fortunately, the banking industry has been stepping up to provide lower cost, small-dollar credit alternatives that allow financially vulnerable households to meet their short-term borrowing needs more sustainably. However, many banks remain on the sidelines, hesitant to develop and introduce small-dollar lending programs. At least in part this is due to perceived regulatory or supervisory risks for these programs arising from:

- Uncertainty about the regulatory and supervisory treatment of such products owing to numerous arbitrary changes made by regulatory agencies in the past
- The possibility that Congress may legislate a national interest rate cap that could result in banks making losses on these products

This post reviews the potential social benefits of bank-provided, small-dollar loans and the sources of regulatory uncertainty that may be impeding their availability. The discussion highlights how more supportive and coordinated treatment by the CFPB and the prudential banking agencies of these products would minimize the regulatory risks for banks that offer small-dollar products, thereby expanding the set of affordable borrowing options for households that struggle to pay small and unexpected expenses.

The Benefits of Small-Dollar Lending by Banks

Given the large share of households that have little or no financial cushion to absorb a small and unexpected expense, there is a clear need for small-dollar credit products that would meet their short-term, small-borrowing needs in a responsible manner. Most lower income households have relied on small-dollar credit products provided by non-banks, such as payday loans, for meeting such expenses.

These nonbank options have a high price to consumers, via very elevated interest rates or fees, and are characterized by lack of disclosure or transparency regarding their likely, ultimate all-in costs to the borrower.

Moreover, these credit products are underwritten with minimal consideration to the borrower's ability to repay. The repayment of such loans is often not affordable, necessitating rollover of the loan.

In contrast, bank-provided small-dollar loans display the hallmarks of a "responsible" small-dollar loan as outlined in a May 22, 2020, No-Action Letter Template to the Bank Policy Institute approved by the Consumer Financial Protection Bureau .[1] The NAL template establishes operating guardrails for a depository institution to offer responsible small-dollar credit products for amounts of up to $2,500. These guardrails are designed to protect borrowers and include considerations for simple and transparent terms and conditions and parameters for repayment terms and underwriting requirements.[2]

Banks' small-dollar loan programs provide temporary liquidity at relatively low cost. These products feature simple and transparent terms that are easily understood by the borrower, eligibility requirements designed to keep delinquency rates low, and restrictions on the rollover of the loan. 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 programs.

Banks' Costs of Introducing and Maintaining a Small-Dollar Loan Program

The start-up costs of a small-dollar lending program can be large relative to the revenues generated. For instance, 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, can entail significant costs.

Ongoing expenses of maintaining an online platform, such as ensuring appropriate cybersecurity protections and mitigating operational risks, would add to these per-dollar costs. Even if spread out or amortized over multiple years of a development cycle, the costs can be relatively high per-loan dollars originated. In addition, a small-dollar loan program entails ongoing marketing and administrative expenses. The latter category includes costs of program management, legal and regulatory compliance, consumer complaint monitoring and auditing.

Losses from non-repayment and costs of servicing interventions (such as negotiating repayment plans) for borrowers that experience repayment difficulties are additional, potentially substantial ongoing costs. Borrowers often face a significant cash flow imbalance at the outset, generating the need for short-term credit and, depending on the eligibility criteria applied by the lender, implying an elevated risk of non-repayment compared to other types of consumer credit from banks.[3]

Regulatory Risks May Be Impeding Progress

The typical banking organization has multiple alternative contenders for the funds it can apply toward developing new or enhanced consumer lending programs, and for the funds it allocates to community development and community reinvestment goals. A bank must make such decisions wisely, to optimize the benefit to its customers and the communities it serves.

From this perspective, banks would be hesitant to develop and introduce a small-dollar credit program without assurance that the program will be sufficiently scalable, can be priced appropriately, and will have sufficient longevity to cover its initial as well as ongoing costs. Risks that a small-dollar lending program will encounter

[1] BPI had applied to the CFPB for the No-Action Letter Template. 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."

[2] A previous BPI research note, "A New Path to Offering Small-dollar Loans," explains the terms and conditions of a responsible small-dollar credit product, which are essentially those delineated in the No-Action Letter Template.

[3] For additional discussion of the costs entailed by a small-dollar lending program, see the previous BPI research note "Costs and Pricing of Bank-Provided Small-dollar Loans."

regulatory obstacles that may preclude appropriate pricing or may cause it to be non-scalable or short-lived can discourage banks from proceeding.

The risk that supervisory treatment of small-dollar programs may change arbitrarily. According to a recent report from the Government Accountability Office, banks have been reluctant to offer small-dollar loans because the supervisory agencies in the past have wavered between supporting and discouraging this lending. As summed up by BPI's Greg Baer: "Banks recognize, based on experience well documented in the report, that any favorable guidance could be rescinded, or that another agency might take a different, even contradictory view."[4]

The GAO report is based on comments received from 18 market participants and observers (nine banks, three consumer groups, five industry groups and one research organization) on the effects of regulatory actions on small-dollar lending. Most of the commenters indicated that "banks are hesitant to offer such loans in part because they are expensive to develop and the regulations or supervisory expectations may change." The latter concern is grounded in historical experience: during 2010 through 2020, the CFPB, Federal Reserve, FDIC and OCC "issued or rescinded at least 19 actions related to small-dollar loans. These actions included issuing rulemakings, statements, agency booklets, and principles."

For instance, some commenters cited the fact that, on multiple occasions, the banking regulators have issued and rescinded supervisory information related to deposit advance products. Some expressed a view that the CFPB's Payday Lending Rule was not sufficiently stable for banks to offer small-dollar loans as the CFPB rescinded part of that rule less than three years after finalizing it.

The historical record of changing supervisory views on small-dollar loans is documented in full detail in the GAO report. Despite recent encouragement of small-dollar lending by the regulatory agencies, such as the CFPB's issuance of its NAL Template, perceptions of regulatory uncertainty persist among banks.

The risk that lawmakers may impose APR limits. Some opponents of payday lending have advocated for a national 36 percent cap on the annual percentage rate (APR) of a loan to protect consumers from becoming dependent on high-cost debt. In July 2021, a group of U.S. senators released a bill intended to protect vulnerable households from entrapment in a cycle of high-cost debt. Their proposal, the *Veterans and Consumers Fair Credit Act*, would extend to all consumers the protections of the Military Lending Act (MLA), including the MLA's 36 percent APR cap on most types of non-mortgage consumer credit (and its special rules for calculating the applicable APR).[5]

As an initial matter, it is important to note that because APR is highly responsive to loan size and term, APR is somewhat limited in its utility as a measure of borrowing costs in the small-dollar context. Nevertheless, it is an important data point that banks must consider when determining whether to offer a small-dollar lending program. Because APR is highly responsive to loan size and term, smaller, shorter-term loans require relatively high APRs to cover the overhead and expenses associated with each loan. Thus, a 36 percent APR cap (or any similarly low cap) could prove to be a deterrent to banks seeking to offer a small-dollar lending program.

A bank would expect to be compensated for program costs through the interest or fees collected from borrowers. Given the cost considerations outlined above, the requisite APR for a small-dollar loan may be substantially higher than 36 percent.

For example, consider a $500 loan to be repaid *over three months*. Realistically, it may cost the bank $25 per loan toward overhead, program maintenance and administrative expenses. The bank may reasonably expect to incur an additional $50, on average, for servicing interventions and credit losses (for example, in the case of a 10 percent

[4] See the BPI blog post "Not Enough Small-dollar Lending by Banks? The GAO Points the Finger."

[5] See the BPI research note "Serious Problems with Using the Military APR Calculation for a Broadly Applied Interest Rate Cap" for a discussion of the difficulties associated with this APR calculation.

default rate with no recovery on the unsecured extension of credit). The expected cost of the loan to the bank is then 15 percent of the loan amount, implying an *annualized* cost at 60 percent, translating into a break-even APR exceeding 60 percent (after adding in the funding cost of the loan).[6] Of course, this APR is still significantly lower than those typically offered by payday lenders. Payday lenders and other nonbank purveyors of high-cost small-dollar loans routinely offer products with an APR that exceeds 300 percent.

Summing up, the overhead, administrative and default costs associated with a small-dollar program can translate into high costs on a per dollar basis because of the small loan sizes. When the loans also have short repayment periods, annualizing this cost can imply a relatively high break-even APR for the loan.[7] Thus, a tangible risk of an APR cap being imposed by future legislation can discourage banks from innovating small-dollar loan programs.

Conclusion

Further clarification, guidance and assurances from regulators are needed to allay banks' worries about supervisory treatment of small-dollar loan programs. Legislative or other actions to curtail payday lending, such as through APR caps, should exempt the responsible, small-dollar loan programs of banks that are consistent with the CFPB's NAL Template.

Encouraging more banks to offer responsible small-dollar credit 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 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.

[6] For further elaboration, including an additional, illustrative calculation, see the BPI publication "What is the Break-Even Cost of a Small-dollar Loan?"

[7] Note that an additional cost to the bank of providing small-dollar credit is that of funding the loans, which of course depends on macroeconomic conditions. 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.