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Is now the right time for banks to resume small-dollar lending?

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WASHINGTON — Despite regulators' appeal for banks to make small-dollar loans available to those hurt by the coronavirus pandemic, the debate still rages over whether financial institutions should compete on the turf of less traditional lenders.

Last week, the Federal Reserve, Consumer Financial Protection Bureau, Federal Deposit Insurance Corp., Office of the Comptroller of the Currency and National Credit Union Administration issued guidance saying supervised institutions were "well-suited to meet the credit needs of customers affected by the current COVID-19 emergency." They could offer small-dollar loans to help consumers and small businesses address cash-flow needs, the agencies said.

But some experts say the statement lacked key specifics that banks have sought from regulators to feel confident competing with payday lenders, such as appropriate loan terms, rate limits and fee structures. Consumer advocates, meanwhile, have raised concerns that regulators are endorsing high-cost loans that have traditionally exacerbated borrowers' financial situation.

“Every time I talk to banks about small-dollar lending, they say it’s going to take more formal guidance and explicit guidance to see banks move into the area permanently,” said Diego Zuluaga, a policy analyst at the Cato Institute. “If I’m a bank but I don’t know what the parameters of this are going to be, I don’t know that [last week’s guidance] is going to make much of a difference,” said Zuluaga.

Still, industry representatives hailed the message validating banks as a responsible resource for small-dollar credit.

“I hate to say this, but I think what we're going through now with the crisis has opened the eyes of even the consumer groups” that small-dollar lending has a place in U.S. banking, said Richard Hunt, president and CEO of the Consumer Bankers Association.

Simple by design

The regulators' guidance sought to highlight the "role that responsibly offered small-dollar loans can play in helping customers meet their needs for credit due to temporary cash-flow imbalances, unexpected expenses, or income short-falls during periods of economic stress."

The bulletin builds on more general guidance from earlier in March when regulators instructed banks to work with customers affected by the pandemic. Yet the statement was also another sign of the full pivot by regulators away from their previous stances during the Obama administration,

when they objected to banks offering payday loan-like products. The FDIC and OCC had effectively banned deposit advance products in 2013. The OCC has since rescinded its ban and the industry has urged the FDIC to do the same. In 2018, the OCC issued a statement of principles encouraging banks and thrifts to help meet customers' short-term credit needs.

The guidance last week did not limit the circumstances, when banks could be seen as appropriate small-dollar lenders, to crises.

"The agencies also recognize that responsible small-dollar loans can benefit financial institution customers in more normalized times when unexpected expenses occur or there are temporary income short-falls," they said.

Regulators say last week’s guidance was simple and non-prescriptive by design, with speed and interagency collaboration being the top priority in order to encourage banks to start helping consumers affected by the pandemic via small-dollar lending as soon as possible. Officials have signaled for months that the agencies are planning more detailed guidance on small-dollar loans.

An FDIC spokesperson argued that the sooner banks offer small-dollar lending products — giving customers more choices of financial methods to weather the pandemic’s economic impact — the better. An OCC spokesman agreed that "banks ... are well-positioned to help meet this need without the harmful practices often associated with other credit sources."

The guidance also attempted to head off concerns about the danger of cyclical debt in small-dollar lending by encouraging institutions "to consider workout strategies designed to help enable the borrower to repay the principal of the loan while mitigating the need to re-borrow.”

Outstanding questions

But small-dollar lending has long been an area of murk for U.S. banks. Not only have there been questions about the profit potential, but banks have often worried about the regulatory implications.

Consumer advocates say the regulators' statement sets the wrong tone.

“Banks generally want to do right by their customers — they want to be responsible lenders,” said Rebecca Borné, senior policy counsel at the Center for Responsible Lending. But small-dollar lending’s steep short-term costs can “take the financially distressed person and leave them worse off, mired in high-cost debt.”

She added that "in even the best of times, the data show that these loans aren't going to help the financially distressed people that they're aimed at.”

But Hunt said banks that previously offered small-dollar loans received positive feedback on the products from consumers.

“I wish this product did not have to exist,” Hunt said. “But the fact of the matter is, once you get outside of the ivory towers of government, you learn that America is hurting, and that America needs quick access to these types of things when they’re thinking about medical bills, the grocery store, or automobile repair.”

The ability of cash-strapped Americans to meet unexpected expenses was on policymakers' radar long before the coronavirus crisis.

A 2018 Fed survey of the economic health of U.S. households found that 61% of respondents could cover a hypothetical, unexpected expense of $400 with cash, savings or a credit card paid off immediately. Among the remaining respondents with insufficient funds, 16% said they would carry a credit card balance while 2% said they would use a payday loan, deposit advance or overdraft protection.

Since 2018, both Comptroller of the Currency Joseph Otting and FDIC Chair Jelena McWilliams have shown interest in encouraging banks to return to small-dollar lending.

If small-dollar lending is "done by banks, we can regulate them," McWilliams said in 2018, shortly after the FDIC began soliciting comment on how best to encourage small-dollar lending by banks. "And we are able to work with the banks on how to ensure the consumer protection protocols are in place and compliant while making sure that the consumers' needs are met."

After the OCC rescinded its 2013 guidance, Otting told reporters that small-dollar lending was "a vehicle to help people get back into mainstream banking and get them off of high-cost financial services products of check-cashing and payday lending."

Since then, a smattering of banks have entered the space cautiously. Most notably, U.S. Bank offers Simple Loan, which allows customers to borrow up to $1,000 in $100 increments with an annual percentage rate that comes out roughly to 36%. Other banks have recently begun to offer small-dollar products directly in response to COVID-19.

Need for proper guardrails

But consumer protection groups have argued that without proper guardrails, such products can only exacerbate customers' financial outlook.

"The guidance ... lacked the most essential piece of responsible small-dollar lending, and that's making sure that the price is reasonable and affordable and that people can afford to repay the loan," said Lauren Saunders, associate director of the National Consumer Law Center.

Of particular concern for advocates was a line from the most recent guidance that listed support for "appropriately structured single payment loans," which they say could open the door to a type of payment scheme used by payday lenders to rack up interest, late fees and other penalties.

"It's distressing to see them emphasize the possibility of single payment loans — that is to say, balloon payment loans and payday loans, which is the last thing that people need right now," Borné said.

Some advocates are also concerned that regulators may be using the crisis as a way to move forward on small-dollar lending reform more quickly.

"It is all the more important today and looking to the immediate aftermath of this crisis to make sure that small-dollar lending is affordable," Saunders said. "And the last thing we need is to use this crisis as an excuse to give the green light for high-cost small-dollar loans."

At the same time, many analysts say that banks, with their access to cheap capital balanced by robust regulation, are the best situated industry to offer affordable small-dollar loans to those who need it.

“Without us, consumers end up in much worse markets of last resort,” said Jared Kaplan, CEO of OppLoans, a fintech that partners with banks to service small-dollar loans using alternative data. “There’s no question that the banks are best-positioned to do this kind of lending.”

“It’s a very positive first step for the regulators to recognize that this market is here and going to get credit — and it’s better to have it in a highly regulated sector,” he said.

Hunt said it is unlikely that a critical mass of banks will step into the space and take business away from predatory lenders if they’re overly restricted by regulators or afraid that a general election could flip the small-dollar lending environment on its head.

“For a bank to start to invest millions of dollars to get back into this, it takes a long-term commitment,” said Hunt. “You can’t just turn it on every four years with a different administration. We need longevity, we need to give the product time to develop.”

The road ahead

Regulators have been tight-lipped on what exactly future guidance might entail. But both banks and consumer advocates anticipate that the regulators could be more specific on appropriate pricing terms.

Consumer groups worry that the coming guidance could enable banks to offer riskier products.

“My fear is that the coming guidance on small-dollar loans is going to be aimed at giving a green light to banks to make high-cost loans, because banks don't need guidance to make affordable small-dollar loans,” said Saunders at the NCLC.

Banks fear the opposite — that regulators will adopt a restrictive 36% interest rate limit. That is the current statutory cap on loans for military service members.

“We certainly don’t want the 36% cap,” said Zuluaga at Cato. Given the risks and costs of lending to customers with the lowest credit scores, he said, “that would just curtail access to credit to those who need it most.”