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STATEMENT OF

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on

AN EXAMINATION OF THE AVAILABILITY OF CREDIT FOR CONSUMERS

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SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT
COMMITTEE ON FINANCIAL SERVICES
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Chairman Capito, Ranking Member Maloney, and members of the Subcommittee, thank you for inviting me to testify on options available to consumers in need of small-dollar, short-term credit. Expanding the availability of mainstream financial services in general, and affordable small-dollar loans in particular, is a significant priority at the Federal Deposit Insurance Corporation.

The FDIC believes that banks already have the tools and infrastructure to create small-dollar credit products that are both affordable for consumers and beneficial for banks. Also, enhancing opportunities to save and bolstering financial literacy can help consumers better manage economic disruptions, and perhaps avoid using short-term credit altogether. Small dollar loan products are a useful business strategy for banks to establish new customers and foster long-term banking relationships. To that end, the FDIC implemented a number of initiatives to help banks stimulate an increase in offerings of reasonably-priced, safe alternatives to high-cost short-term credit and to improve consumers' overall financial resilience. Our testimony addresses these initiatives in more detail, including the results of the FDIC's Small Dollar Loan Pilot Program.

Demand for Short-Term Credit is High

In the wake of the longest economic recession since the 1930's and against the backdrop of persistently high unemployment, record foreclosures, a moribund housing market, and stock market volatility, many U.S. households are struggling to make ends meet, and do not have the capacity to deal with further financial shocks. A paper published earlier this year showed that one-half of U.S. households are "financially fragile" in that they would "probably" or "certainly" be unable to cope with a short-term financial emergency.[1]

Not surprisingly, in this economic environment, there is a large demand for small-dollar credit to cover emergencies, but all too often, consumers turn to high-cost products to meet their needs. For example, estimates peg payday loan volume to be in excess of $38 billion annually[2] and annual revenue from overdraft fees at about $38 billion.[3] Annual percentage rates (APRs) for these products can top several hundred -- or even thousand -- percent, putting more stress on already weakened consumer balance sheets.

The effects of high-cost credit can be particularly significant for lower-income consumers. According to the most recent Federal Reserve Board Survey of Consumer Finances, one in five consumers in the lowest income quintile ($20,600 or less) had zero or negative net worth.[4] Moreover, the *FDIC's Survey of Unbanked and Underbanked Households* in 2009 found that nearly 20 percent of households with incomes of $30,000 or below had used non-bank companies for credit needs rather than banks.[5]

[1] Annamaria Lusardi, Daniel J. Schneider, Peter Tufano, "Financially Fragile Households: Evidence and Implications" Working Paper 17072, National Bureau of Economic Research, Cambridge, Massachusetts, May 2011. Data were collected between June and September 2009 from a statistically representative sample of 2,148 U.S. households. In response to the question "How confident are you that you could come up with $2,000 if an unexpected need arose in the next month?," 24.9 percent reported being "certainly able" to cope; 25.1 percent reported being "probably able" to cope; 22.2 reported being "probably unable" to cope; and 25.1 percent reported being "certainly unable" to cope.

[2] Jessica Silver-Greenberg "Payday Lenders Go Hunting," *Wall Street Journal,* December 24, 2010, which, cites a year-end 2009 report from Stephens, Inc. as the source for the estimate.

[3] Moebs Services, press release: "Overdraft Fee Revenue Drops to 2008 Levels for Banks and Credit Unions," September 15, 2010, which projects overdraft revenue at $35 billion in 2010 and $38 billion in 2011.

[4] 2007 Survey of Consumer Finances," Federal Reserve Board.

[5] "FDIC National Survey of Unbanked and Underbanked Households," FDIC, Washington, DC. December 2009. The household survey was conducted in January 2009 as a supplement to the U.S. Census Bureau's Current Population Survey. http://www.fdic.gov/householdsurvey/Executive_Summary.pdf

FDIC Efforts to Encourage Banks to Offer Affordable Small-Dollar Loans

A generation or so ago, it was common for banks to make small, unsecured loans to individuals. However, over time, a series of product and technological innovations and changes in the competitive landscape in banking, among other factors, contributed to a decline in the number of banks offering small loans and an increase in alternative credit providers, such as payday loan stores, auto title lenders, and pawn shops that often offer costly credit products. Not long after, many banks began to offer automated fee-based overdraft products on a wider scale that also can be a costly way for consumers to deal with financial emergencies. The *FDIC Study of Bank Overdraft Programs* in 2008 illustrates the steep costs of automated fee-based overdraft programs; it showed that the median overdraft was $36, but the median fee to cover overdrafts was $27.[6]

The FDIC began reviewing whether banks could feasibly offer alternatives to high-cost short-term credit in the context of military personnel, whose financial problems can collectively affect the readiness of our armed forces. More specifically, in December 2006, the FDIC held a conference, titled "Affordable, Responsible Loans for the Military: Programs and Prototypes" where attendees, including banks, representatives from the Department of Defense and other agencies, community groups, and others developed a template for an affordable, small-dollar loan program.

Subsequently, in a broader effort to encourage more banks to offer small-dollar credit products that are affordable, yet safe and sound and consistent with all applicable federal and state laws, the FDIC issued the *Affordable Small-Dollar Loan Guidelines* (the

[6] "FDIC Study of Bank Overdraft Programs," FDIC, Washington, D.C. November 2008. Data refer to automated overdraft programs.

Guidelines) in June 2007. The Guidelines explore several aspects of loan product development, including affordable prices, reasonable loan terms, streamlined underwriting, and the benefits of linking a savings component and financial education to short-term loan products. Importantly, the FDIC recognizes that the Community Reinvestment Act (CRA) could also provide a valuable incentive to offer affordable small-dollar loans. The Guidelines clarify that FDIC institutions providing such products consistent with the Guidelines will receive favorable consideration in the CRA examination.

Building on the Guidelines, the FDIC Board of Directors in June 2007 also approved a two-year case study known as the FDIC Small-Dollar Loan Pilot Program (the Pilot) to determine the feasibility of banks offering small-dollar loans as an alternative to high-cost emergency credit sources, such as payday loans or fee-based overdraft programs. The idea for the Pilot originally stemmed from a recommendation by the FDIC's Advisory Committee on Economic Inclusion (the Committee), which was established in 2006 to provide advice and recommendations to the FDIC regarding expanding access to banking services for the one-quarter of U.S. households that are underserved.[7] The Committee is comprised of representatives from banks, academia, consumer and community groups, and government agencies.

Like all of us, underserved consumers need to cash their paychecks, pay bills, and save for the future with products that are safe, affordable, and easy to understand. They

[7] The 2009 FDIC National Survey of Unbanked and Underbanked Households (See Footnote 4) found that 7.7 percent of U.S. households are unbanked, meaning that they lack a checking or savings account at an insured financial institution, while 17.9 percent of U.S. households are underbanked, meaning that they have a deposit account at an insured financial institution, but continue to rely on alternative financial services providers

also need access to reasonably-priced credit to buy a car or a home, pay for their children's education, and, of particular relevance to this hearing, to meet unexpected short-term financial needs. The Committee provides a forum to stimulate discussion and obtain information about these and other important issues and challenges facing underserved consumers.

The Pilot was launched in February 2008, and concluded as of the fourth quarter 2009. Twenty-eight volunteer banks participated with total assets ranging from $27 million to $10 billion, and almost 450 branches in 27 states. During the Pilot, banks made 34,400 loans with a principal balance of $40.2 million. While delinquencies on loans originated under the Pilot tended to be 3 to 4 times higher than for unsecured consumer loans in general, charge-offs were in line with the charge-off ratios for unsecured consumer loans in general. The Pilot has resulted in a model, or template, of product elements for a safe, affordable, and feasible small-dollar loan. Product elements include loan amounts of $2,500 or less, loan terms of 90 days or more, APRs of 36 percent or less, low or no fees, streamlined but solid underwriting, and optional savings and financial education components. The template is replicable in that it is simple and requires no particular technology or other major infrastructure investment to implement.

Best practices and elements of success emerged from the Pilot and underpin the template. In particular, a dominant business model emerged: most Pilot bankers indicated that small-dollar loans were a useful business strategy for developing or retaining long-term relationships with consumers. In terms of overall programmatic success, bankers reported that long-term support from a bank's board of directors and senior management was most important. The most prominent product element bankers linked to the success of their program was a loan term longer than just a few pay cycles to give consumers time to repay. Perhaps most importantly, the Pilot shows that banks can offer affordable small-dollar loans in a manner that suits their business plans and is fair to consumers. In testament to that fact, 26 of the 28 institutions continue to offer the product today even though the pilot program terminated in 2009.

Going forward, the FDIC is working with the banking industry; consumer, community, and philanthropic groups; other government agencies; innovators in small-dollar lending; and others, to research and pursue strategies that could prove useful in expanding the supply of small-dollar loans. Among other things, these strategies include:

- Highlighting the successful features of the Pilot and other small-dollar loan models.
- Studying the creation of pools of nonprofit or government funds to serve as "guarantees" for small-dollar loans.
- Encouraging broad-based partnerships among banks, nonprofit organizations, and community groups to work together in designing and delivering small-dollar loans.
- Studying the feasibility of safe and innovative emerging small-dollar loan technologies and business models.
- Considering ways that regulators can encourage banks to offer safe and affordable small-dollar loan products and that these products can receive favorable CRA consideration.

Additionally, the FDIC has engaged in a number of initiatives, briefly described below, to improve the overall financial well-being of consumers and reduce their need to tap credit sources when financial shocks arise.

FDIC Model Safe Accounts Pilot

In August 2010, the FDIC Board approved a case study, recommended by the Committee, designed to evaluate the feasibility of financial institutions offering safe, low-cost transactional and savings accounts that are responsive to the needs of underserved consumers. Known as the Model Safe Accounts Pilot, the study launched in January 2011 and will run over the course of a year. The study includes nine financial institutions that volunteered to offer unbanked and low- and moderate-income consumers deposit accounts with core features for safe, low-cost transactional and basic savings account products based on account templates that were published for comment in May 2010.

The account templates address predominantly electronic accounts to limit acquisition and maintenance costs. Transactional accounts are card-based, electronic accounts that allow withdrawals through automated teller machines, point-of-sale terminals, automated clearinghouse preauthorizations, and other automated means. As needed, and on a limited basis, transactional accountholders may obtain money orders, convenience checks, or e-checks. There are no overdraft or non-sufficient funds fees associated with the transactional accounts. All of the accounts are FDIC-insured; are subject to applicable consumer protection laws, regulations, and guidance; and have reasonable rates and fees that are proportional to their cost.

As with the Small Dollar Loan Pilot Program, results of the Model Safe Accounts Pilot will be analyzed to determine best practices to share with the industry to encourage more banks to offer similar products. Over the long term, expanded access to safe and affordable bank accounts could provide more undeserved consumers with the option of tapping savings for emergencies, rather than relying on high-cost forms of credit.

Financial Education: the Money Smart Initiative

Clearly the need for small dollar short-term loans could be ameliorated if consumers became more knowledgeable about personal financial management. To address this and other needs on the part of consumers, the FDIC initiated a national financial education campaign in 2001 by launching *Money Smart*, a comprehensive financial education curriculum designed to help individuals outside the financial mainstream develop financial skills and positive banking relationships. Over 2.75 million consumers have been reached with Money Smart and over 1,200 organizations are actively part of the FDIC's Money Smart Alliance. Money Smart is available today in seven languages and comes in adult and young adult versions. In addition to the original version designed to be taught in a group setting, it is also available for consumers to complete independently online or through an MP3 player.[8]

A 2007 study of the effectiveness of Money Smart showed that the curriculum can positively influence how participants manage their finances. A majority of the Money Smart graduates surveyed reported an increase in personal savings, a decrease in debt, a better understanding of financial principles, and an increased willingness to comparison shop for financial services.

The FDIC continues to form alliances with public, private, and non-profit entities to promote financial education and encourage linkages between financial education and access to mainstream banking services. For example, last November, the FDIC entered into a partnership with the U.S. Department of Education and National Credit Union Administration to facilitate partnerships among schools, financial institutions, federal

[8] http://www.fdic.gov/moneysmart

grantees and other stakeholders. The partnerships provide effective financial education, increase access to safe, affordable and appropriate accounts at federally insured banks and credit unions, and encourage saving.[9] In addition, approximately 230 of the more than 1,200 organizations recognized as Money Smart Alliance Partners are financial institutions or their trade groups. Many of these institutions are using the Money Smart curriculum in collaboration with community-based partners by, for example, delivering the curriculum or providing bank products responsive to the needs of Money Smart program participants.[10]

Alliance for Economic Inclusion

Another area where the FDIC has addressed the needs of underserved consumers is through the Alliance for Economic Inclusion (AEI). AEI is the FDIC's national initiative to establish coalitions of financial institutions, local policymakers, community-based and consumer organizations, and other partners in 14 markets across the country to bring unbanked and underserved populations into the financial mainstream. The focus of AEI is on expanding basic retail financial services to underserved populations, including savings accounts, affordable remittance products, small-dollar loan programs, targeted financial education programs, and asset-building programs. AEI has approximately 1,130 members nationwide, and a number of the banks participating in the AEI also offer affordable small-dollar loan programs.

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[9] http://www.fdic.gov/news/news/press/2010/pr10251.html

[10] See, for example, Financial Institutions Encouraged to Work With Schools to Promote Youth Financial Education, FIL-80-2010, http://www.fdic.gov/news/news/financial/2010/fil10080.html

FDIC Unbanked and Underbanked Surveys and Other Consumer Research

Section 7 of the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 (Pub. L. 109-173) requires the FDIC to conduct ongoing surveys "on efforts by insured institutions to bring those individuals and families who have rarely, if ever, held a checking account, a savings account or other type of transaction or check cashing account at an insured depository institution into the conventional finance system." The Act further requires the FDIC to provide a "fair estimate of the size and worth of the 'unbanked' market in the United States."

To satisfy the congressional mandate, the FDIC designed two complementary national surveys, the 2008 *FDIC Survey of Bank Efforts to Serve the Unbanked and Underbanked* and the 2009 *FDIC National Survey of Unbanked and Underbanked Households* (referenced above). The results of these surveys provided new and valuable information to policymakers, the banking industry, consumer groups, and other organizations interested in expanding safe and affordable financial access to underserved populations. We are repeating the surveys this year.

In addition to the surveys, the FDIC provides research, data, and other resources for consumers, banks, policymakers and others regarding issues related to consumer protection, underserved populations, savings, credit, and the use of alternative financial services. All of this information is available on www.economicinclusion.gov, an award-winning website maintained by the FDIC that is designed to centralize and disseminate information about our economic inclusion efforts.

Conclusion

The FDIC issued guidelines to encourage banks to offer affordable small-dollar credit products, conducted a pilot program to demonstrate the feasibility of banks offering these products, and continues to explore strategies to scale small-dollar lending across the financial mainstream. Also, the FDIC has pursued initiatives to increase underserved consumers' access to savings and financial literacy as an option to potentially avoid costly forms of emergency credit. Through these steps, and by working with other interested groups, the FDIC looks forward to the day when affordable small-dollar loans become a staple product at all banks, helping American families address their short-term credit needs in a safe, reliable and financially sound manner.