CFSI Center for Financial Services Innovation

Written Testimony of
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House Subcommittee on Financial Institutions and Consumer Credit

An Examination of the Availability of Credit for Consumers

September 22, 2011

Thank you, Chairman Capito, Vice Chair Renacci, and Ranking Member Maloney. On behalf of the Center for Financial Services Innovation, I appreciate the opportunity to participate as a witness before the House Financial Services Subcommittee on Financial Institutions and Consumer Credit on the matter of underbanked consumers' access to credit. We appreciate the Subcommittee's attention to the state of consumers' access to credit, particularly in this economic environment.

I am the vice president of policy for the Center for Financial Services Innovation. CFSI is a national nonprofit organization, in its eighth year of providing national leadership, research, and insights on the non-mortgage, retail financial services needs of underbanked consumers. We conduct consumer and industry research to develop a broad understanding of consumers in this segment and the products offered to them. We hold twice-yearly roundtables with large and small financial services providers and nonprofits to develop and advance products and strategies for serving underbanked consumers. Each year we bring together over 500 representatives from the financial services sector, including innovators, nonprofits, and policymakers, to spotlight how innovation, partnerships, and public policy can improve financial services for underbanked families. We provide grants to nonprofits that are building underbanked consumers' financial capability through the marriage of financial education and products and technology.

Finally, we develop and champion federal policy to spur financial product innovation and market competition and address impediments to access to high-quality financial services. We believe that effective public policy must protect consumers from harmful products and practices; ensure that consumers have access to safe and affordable products and services; and ensure that providers operate safely and soundly. Our vision is to see a strong, robust, and competitive financial services marketplace, where the diversity of consumer transaction, savings, and credit needs are met by a range of providers offering clear and transparent products and services at reasonable prices.

My testimony will provide insights on the small-dollar credit marketplace and recommendations for public policy. These comments are based on our consumer research and our observations of market practices. We pay particular attention to consumers' need for small-dollar credit and emerging product innovations with the potential to extend wide-scale credit access to underbanked consumers, responsibly and affordably. We believe that well-structured credit products can help consumers address short-term credit needs and build positive credit histories, critical for employment, insurance, and housing, as well as for longer-term asset building. We believe quality credit is marketed transparently and priced fairly, and that it is affordable and structured to support repayment without creating a cycle of repeat borrowing.

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The State of Underbanked Consumers and Small-Dollar Credit

CFSI research focuses on unbanked and underbanked consumers and the ways that the financial services industry meets, or could meet, their needs. We define "unbanked" consumers as those without a checking or savings account, while "underbanked" consumers may have one or both accounts but also use alternative financial services such as check cashers or payday lenders. In a 2009 study assessing the size and make-up of the unbanked and underbanked population, the FDIC found that 30 million American households—approximately one in four—are either unbanked or underbanked. Compared to the general population, these households are more likely to be classified as low to moderate income. The FDIC found that approximately two-thirds of unbanked and underbanked households had annual incomes below $50,000, roughly the median income of all American households.[1]

In 2008, prior to the FDIC study, CFSI conducted a nationally representative survey of unbanked and underbanked consumers to gauge their numbers and explore their preferences, behaviors, and challenges related to financial services. We found that almost one-third of unbanked or underbanked consumers had borrowed for small-dollar needs in the prior 12 months, and that they borrowed from a variety of sources, including rent-to-own centers, pawnshops and payday lenders, as well as from friends, family, and financial institutions. While the reasons for their most recent borrowing varied, over a third cited the need to pay bills and basic living expenses as their motivation for seeking out credit.[2] This suggests that, in addition to helping address unexpected emergencies, unbanked and underbanked consumers use credit to manage expenses, perhaps in the face of volatile or unpredictable incomes.

A lack of sufficient credit history or a damaged credit profile can often serve as an impediment to qualifying for high-quality credit products. Our survey found that as much as 75 percent of the unbanked and underbanked population had credit scores that would be considered subprime or lacked enough credit history to generate any score at all. For these households, credit providers such as payday lenders and pawnshops may be one of few options available in today's marketplace to meet a credit need.

In the current economic environment, there have been signs that an increasing number of households may be in a similar position, unable to access high-quality credit products. Millions of households have suffered foreclosures or bankruptcies that likely damaged their credit profile. The sustained period of high unemployment has created additional financial challenges for Americans, and middle-class incomes have stagnated, as indicated by the 2.3 percent decline in the median income in 2010.[3] At the same time, banks rapidly tightened lending standards for credit cards and consumer loans following the financial crisis in an attempt to protect and rebuild their portfolios.[4]

With this widening access gap caused by declining credit profiles and elevated underwriting standards, an increasing number of households appear to be finding it difficult to access good credit

[1] *FDIC National Survey of Unbanked and Underbanked Households*, Federal Deposit Insurance Corporation (December 2009); and *Income, Poverty, and Health Insurance Coverage in the United States: 2010*, U.S. Census Bureau (September 2011).

[2] *Underbanked Consumer Study*, Center for Financial Services Innovation (June 2008–February 2009), http://cfsinnovation.com/publications/list/CFSIUnderbankedConsumerStudy.

[3] Employment statistics from the U.S. Department of Labor; income statistics from the U.S. Census Bureau.

[4] Federal Reserve Board, Senior Loan Officer Opinion Survey on Bank Lending Practices.

options and are turning to alternative credit providers in the face of limited options. Our belief that this transition is taking place has been bolstered by estimates of growth in payday loan volume during 2010. It is also supported by the FDIC Underbanked Survey, which found that 43% of payday loan borrowers say they use alternative credit because it is easier to qualify for a payday loan than a bank loan. In the coming months, we will launch a new study to better understand the profile of today's small dollar credit borrowers, the factors that influence consumers' product choices, and the implications of those decisions.

Promising Small-Dollar Credit Product Developments

Beginning in 2009, consumer credit levels dropped for seven consecutive quarters, declining 6.6 percent in all.[5] This change resulted from retraction on the part of both credit providers, who tightened lending standards and charged off delinquent balances, and consumers, who increased their savings and debt repayments during the recession. The main driver of the trend was a substantial drop-off in revolving debt, which is typically associated with credit cards, the most common mainstream option for meeting small-dollar loan needs.

Revolving debt posted its first increase in several years in the most recent fiscal quarter. But amid softness in the credit card market, a variety of providers, both in and out of the financial mainstream, have been offering new and existing small-dollar loan products. A few new and modified products have emerged over the past five years to meet the demand for small-dollar credit, with some focused on consumers who lack access to more traditional credit products. A handful of banks and nonbank providers have been developing offerings with promising product structures, terms, and features that make it more viable to serve the underserved market. Described below are some innovations designed to better guide customers toward successful repayment and improved financial outcomes:

- **Offering flexible loan terms that allow customers to choose a repayment plan that fits their budget.** By either offering installment loans or providing the option for installment payments, some providers are allowing customers to spread out their debt service payments, making payments lower than they would be with loans requiring a single, short-term repayment. Customers may find the lower payments easier to fit into their regular budgets.

- **Gathering and analyzing a variety of customer data to improve the ability to underwrite credit for consumers with insufficient or poor credit history.** Certain providers are demonstrating a level of sophistication in analyzing customer data—generated internally and purchased from outside sources—to develop ways to underwrite customers who do not qualify for mainstream credit sources.

  In the case of new credit products linked to transaction products (e.g., checking accounts and prepaid cards), providers can monitor customers' cash inflows and outflows and use the information as a cost-effective way to gauge ability to repay. To date, this practice has largely been limited to setting credit lines at a percentage of customers' paychecks or direct deposit payments, which may not be sufficient to tell whether a consumer will be able to repay a loan without needing to borrow again soon. However, further refinements in using transaction data to assess customers' financial profile may lead to efficient and effective underwriting that lowers costs for providers while giving customers loans they can afford.

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[5] G.19 release, Federal Reserve Board G.19 (September 8, 2011).

- **Creating new and more efficient platforms to handle the application process, the distribution of funds, and customer interactions to reduce operations costs.** By leveraging technology and interfacing with customers online, providers are finding ways to offer credit products more efficiently and reduce the costs of operating a loan program relative to models that rely on physical distribution and in-person customer interactions.

- **Linking credit offerings with other financial products, particularly those that facilitate savings.** This practice allows loan providers to establish broader and potentially more profitable relationships with customers. As many of these emerging products are geared toward underserved consumers, some providers are offering their small-dollar loan products as part of a larger suite of financial services, such as check cashing and remittance services, that meet the target customer's needs. Particularly promising are those that link credit products with savings accounts, often by folding contributions to a savings account into installment payments. This link can help customers establish savings to manage future cash shortages and benefit providers by potentially generating collateral for outstanding loans.

- **Using small-dollar credit as a tool to help consumers build or repair their credit.** A number of credit unions, banks, and nonprofit organizations have designed loan programs specifically to give consumers an opportunity to generate positive credit history, improve their credit profile, and qualify for mainstream loan products. Although we have not seen any one provider achieve significant scale with such a program, and many require a subsidy to operate, anecdotal evidence suggests such programs can facilitate credit building.

- **Using mobile technology to provide financial information relevant to borrowing decisions.** Many financial services providers now allow customers to access information about their transaction accounts (e.g., current balances) through their mobile phones. For credit products linked to transaction accounts, using the mobile channel to provide account information or send messages about the consequences of borrowing could help ensure that customers make informed credit decisions—critical in the wake of foreclosures, unemployment and other economic challenges.

Some providers have developed or adopted these innovations in an attempt to create a viable and sustainable small-dollar loan product for the underserved market. In particular, practices that leverage technology to increase operational efficiency and reduce credit losses have shown promise as a means to improve the business case for small-dollar loans. Other innovations, such as credit-building loans and loan-loss reserve programs, can benefit consumers by positioning them for successful repayment and offering opportunities to access high-quality credit products in the future. These two categories of innovation highlight what we see as the primary challenge of designing small-dollar loans: creating products that are profitable for providers and also safe, responsible, and useful for consumers. While the innovations and practices highlighted represent promising approaches, some also come with concerns and challenges that still need to be addressed.

Challenges to the Expansion of Responsible Small-Dollar Credit

While many new and emerging products and trends suggest promise for those in need of small-dollar credit, there are significant challenges to the growth of responsibly designed small-dollar credit, and critical concerns remain with many such products in the market today. Many if not most of today's products are short-term, often with full repayment due in a matter of weeks, or when the next paycheck arrives. Some products draw the full repayment directly from the consumer's deposit account, which on one hand is a means to gauge income and reduce the likelihood of default, but on the other may leave the consumer little income to live on. While such short-term credit products may be manageable for some consumers, for others the rapid repayment may make repayment impossible. As a result, some consumers are launched into cycles of debt, where they can repay a loan only by borrowing again.

Regulatory scrutiny of the products is warranted, and better consumer protections as well as additional research are needed to shed light on how small-dollar credit products can be designed to avoid rollovers and over-indebtedness, and help consumers manage the credit and build good credit histories.

Policymakers and small-dollar credit providers must find the right balance between product sustainability and ensuring affordability, while protecting consumers in ways that do not overly constrict product offerings. At some level, restrictions that are too tight on providers could make it unviable to offer small-dollar loans to the underserved, causing regulated companies to exit the market and leaving consumers without access to above-ground consumer credit. Conversely, placing too little emphasis on consumer protections leaves open the door for unaffordable and abusive products. A strong base of research and careful analysis of the dynamics in the evolving small-dollar loan market, along with the careful and consistent application of consumer protections, will be essential.

While more work is necessary to ensure responsible product design, it is also important to call out challenges that appear to constrain wide-scale availability of high-quality small-dollar credit. Those factors include capital constraints for certain lenders, regulatory inconsistency and uncertainty, negative stigma associated with small-dollar credit providers, and insufficient underwriting methods that inadequately assess risk. These factors, coupled with the financial crisis, have made it especially challenging for smaller providers to access the needed capital to scale up their businesses and achieve a sizeable volume.

Policy Recommendations

Based on our consumer research and the developments emerging in the market, we offer the following suggestions for policymakers to address both consumers' and providers' need for clarity and certainty with respect to consumer protections in the small-dollar credit marketplace. These recommendations will help to define the safeguards and ensure they are consistently applied across the range of small-dollar credit products and providers. With a few ground rules and a level of regulatory consistency, more and better small-dollar credit products will emerge that we believe will help consumers safely access credit, push down prices, and allow for product diversity and innovation.

First, policymakers should support the Consumer Financial Protection Bureau, as it is the appropriate federal regulator to create and ensure consistency and balanced rules for consumers and providers alike, regardless of the type of entity providing the credit product.

As the federal consumer protection regulator with rule writing, supervision, and enforcement authority over many if not most bank and nonbank credit products, the CFPB will develop considerable knowledge about the range of small-dollar credit lenders and products. And as defined in Title 10 of the Dodd-Frank Financial Reform and Consumer Protection Act, the CFPB's mission is to enforce federal consumer financial laws consistently to ensure that all consumers have access to markets for consumer financial products and services and that those products and services are fair, transparent, and competitive.[6] We believe the statute and the approach that those leading the bureau have taken will result in a rich understanding of consumers using these credit products as well as a comprehensive picture of the full range of small-dollar credit providers. This, we believe, will lead to informed rules that are responsive to different financial services business models and better attuned to the needs and risks for consumers.

Part of the CFPB's mandate is to ensure efficient and effective coordination with the other federal regulators as well as state regulators. Regulatory coordination and, to the extent possible, regulatory consistency with other federal and state regulators is critical for a safe and reasonably priced financial services market. An uneven regulatory environment causes an uneven playing field, making financial products and services confusing and risky for consumers. An uncoordinated regulatory environment also allows for inconsistencies and inefficiencies in the production, marketing, and selling of financial products and services, particularly when more than one regulated party is involved.

The current regulatory unevenness has contributed to skepticism and distrust of the nonbank sector. It has also hampered market competition, as some providers have sought to leverage the differences between state and federal regulation for their own advantage. Once the CFPB's nonbank authority is in place, it will level the playing field with its ability to write, examine for, and enforce federal consumer protection rules covering both banks and nonbanks. The resulting regulatory consistency will create a policy environment that better supports innovation and enables a diverse financial services marketplace to thrive. One of the most important steps the CFPB can take to improve the quality of practice in the nonbank financial services sector is to coordinate supervision with the other federal and state regulators. This would include shared policy goals, common rules, joint exams, and coordinated guidance. Despite the additional effort required, we believe a coordinated approach would bring benefits to consumers and providers, such as cost and price reductions, product advances, and greater consumer access.

Second, as the federal regulator that will have authority over the range of financial products and services, the CFPB should develop and implement consumer protection rules that will ensure safeguards for consumers across the range of small-dollar credit products and providers.

We offer some consumer protection recommendations to make sure small-dollar credit, regardless of type or provider, is prudently provided, manageable, and helps consumers meet short-term financial needs while building positive credit records.

- **Encourage lenders of all types to assess the consumer's ability to repay and successfully manage the credit product**. While many consumers clearly value convenience and the ease of a

[6] "The Bureau shall seek to implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive." H.R. 4173, 111th Congress: Dodd-Frank Wall Street Reform and Consumer Protection Act, Title X, Subtitle B, GovTrack.us (database of federal legislation), 2009.

credit application process that is not predicated on extensive underwriting or a good credit record, lenders should be encouraged to assess the consumer's ability to succeed with the loan, which may mean examining information in addition to the record of prior credit or deposit activity. While there are a myriad of ways lenders can assess a consumer's ability to successfully manage the loan, we recommend regulators study and encourage lenders to assess a consumer's ability to pay using such metrics as whether the consumer used one loan to pay off another loan; what the consumer's debt burden is beyond the loan; how much of the next income deposit or paycheck is being advanced; and what will remain in the consumer's account (in the case of a deposit advance product) to cover other living expenses after the payment is made. While performing this fuller analysis may affect the amount and the price of credit offered to consumers, this type of underwriting will help to ensure that the programs are safe for consumers.

- **Encourage lenders to structure the credit to reduce the likelihood of cycling debt.** The length of the loan, the number of repayments, and the amount borrowed each affect the likelihood of the consumer's success with the loan product. While short-term loans may be manageable for some consumers, products with very short terms are problematic for others. Based on recent trends and practices by small-dollar credit innovators who are testing new product structures, good practices to encourage safe use of small-dollar credit would entail: providing the option for longer repayment periods; providing the option to pay back the loan with multiple payments, rather than just one; calibrating the amount of the credit to reflect a consumer's ability to repay; and starting the credit extension with small amounts that can grow larger as the consumer shows success with the product. We believe these changes will better ensure repayment and avoid defaults, thus helping consumers maintain credit access.

- **Encourage lenders, particularly banks that offer multiple forms of credit, to routinely assess credit use and offer products that are most appropriate and affordable.** Ideally, providers would frequently review consumers' use of credit products and help them find the products that best fit their needs and are most affordable. For some consumers in need of small-dollar credit, products with longer terms and multiple repayment structures, such as installment loans or secured or unsecured credit cards, may be more appropriate than single-payment, shorter-term credit, and many consumers may already qualify for those products.

- **Prevent overuse of small-dollar credit products.** Heavy use of small-dollar credit may indicate a consumer's financial distress. If the provider has taken steps to offer credit with longer terms, multiple repayments, grace periods, or other affordable credit products, and the consumer still cannot repay the credit without having to borrow again, a good practice would be to require meaningful cooling-off periods, allow the consumer to repay the existing credit in manageable installment payments, and encourage the consumer to seek assistance in financial management, potentially through partnerships with reputable credit counseling agencies.

- **Clarify disclosure requirements for all pertinent information.** Lenders should give consumers information about their loans, including the amount, the due date, the reporting of payments to the credit bureaus, and the price and any fees that could be incurred. Terms should be clear, simple, and tested for understandability. The lender ideally also should inform consumers about their prior credit use and provide information about the long-term costs of using the credit product repeatedly.

Finally, policymakers should encourage lenders to design credit products to help customers succeed with the products and build positive credit histories.

- **Help consumers build their credit by reporting repayment activity to the major credit bureaus.** For some consumers, a small-dollar credit product is the only credit option. Others may have access to different types of credit, but their credit may be blemished. In either case, repayment activity on the responsibly designed credit product, if it is reported, can be an important way for the consumer to build or rebuild a positive credit record. Providers offering small-dollar credit should design their products to not only report payment activity, but also to make sure that the reports are successfully incorporated in consumers' credit records.

- **Incorporate financial capability tools into small-dollar credit products.** Well-informed, financially capable consumers are critical for an effective financial services market. Some small-dollar credit products are being developed that provide consumers with resources and features to track and manage credit, build savings, and establish a positive credit history. While these practices are not yet widespread, they are important, positive developments that policymakers can and should encourage.

Thank you, Chairman Capito, Vice Chair Renacci, and Ranking Member Maloney. I hope these insights and recommendations prove useful as you seek to ensure underbanked consumers have access to products that are responsibly designed and easy for all consumers to use safely. I look forward to your questions.

CFSi Center for Financial Services Innovation

September 20, 2011

United States House of Representatives
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I, Carol Brown, Vice – President Finance and Operations for Center for Financial Services Innovation can attest to the fact that we have not received any Federal grants or contracts within the current and prior two fiscal years.

Sincerely,

Carol Brown

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