



IABG | Illinois Asset Building Group
Building financially strong families and communities

Alternative Small Dollar Loans: Building the Business Case

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Illinois Asset Building Group: The Illinois Asset Building Group (IABG) is a diverse statewide coalition invested in building the stability and strength of Illinois communities through increased asset ownership and asset protection. Made up of community leaders, service providers, researchers, advocates, financial institutions, and business leaders, IABG seeks to expand asset building opportunities in Illinois through effective policy and system changes with a specific focus on individuals, families and communities that are disenfranchised from the financial mainstream, including communities of color, people with low-incomes and their communities.

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Alternative Small Dollar Loans: Building the Business Case

Short term, small dollar loans are often a necessity for many people who are trying to make ends meet. Unfortunately, the current market for these loans is primarily limited to high-cost payday loans. In Illinois, nearly 1.2 million payday loans were issued between 2006 and 2008.¹ Payday lenders claim that they provide a needed service to those underserved by mainstream financial institutions; consumer advocates contend that payday loan products are predatory and require regulation. There is no disagreement, however, that high-cost products are filling the growing need for short-term credit.²

The virtual absence of responsible products to meet this need for credit creates an opportunity for mainstream financial institutions to regain consumer trust lost during the recent economic downturn. A handful of banks and a greater number of credit unions offer innovative sustainable alternative small dollar loan products that meet consumers' financial needs.³ Yet, despite the opportunity presented in the current financial climate, most financial institutions have been reluctant to create these programs, citing potential resistance from regulators concerned with possible high risk, perceived reputational danger to the institution for offering a product traditionally associated with predatory lenders and doubt among institutions about the financial benefits of small dollar loans.⁴

Alternative small dollar loans will not become widely available unless a business model is developed that includes economic benefits.⁵ As the Federal Deposit Insurance Corporation's (FDIC) stated,

“A straightforward way to encourage more banks to offer small-dollar loans is to emphasize the facts about successful programs. The key facts are that safe, affordable and feasible small-dollar lending does occur in mainstream financial institutions; that small-dollar lending can be part of a cornerstone for creating profitable relationships; and that defaults on these loans are in line with other types of unsecured credit.”⁶

Using case studies from existing product offerings, this paper highlights financial institutions' innovation and experimentation with providing these products. These case studies include many of the small but growing number of financial institutions in Illinois that offer alternative small dollar loan products, as well as other non-Illinois institutions that offer helpful models. Although many of these case studies are of not-for-profit credit unions, all financial institutions share an interest in providing sustainable financial products that responsibly meet consumer demand and assist the firm in remaining solvent and well-capitalized.

Regulators of financial institutions are also seeking to promote the profitable and responsible offering of alternative small dollar loan programs.⁷ The FDIC recognizes the dual goal of creating “safe and sound small-dollar credit programs [providing] credit that is both reasonably priced and profitable.”⁸ FDIC Chairman Sheila C. Bair is leading her agency to determine how safe and affordable small-dollar lending can be expanded and become a more widely available product for all banks.⁹ The National Credit Union Administration (NCUA) has stated that “under the proper regulatory framework, [Federal Credit Unions] can offer their members a reasonable alternative to high-cost payday loans and be a source of fair credit.”¹⁰

Consumer advocates, financial institutions and their regulators and trade associations have begun working together to develop responsible, alternative small dollar loan products that meet consumers' needs and reduce reliance on predatory lending practices. In addition, current financial market conditions, including a spotlight on consumer protections and providing innovative products for the underbanked, have created a valuable opportunity for mainstream financial institutions to create, implement and market alternative small dollar loans. Researchers

have shown that the wealth-building potential among payday loan users is enormous given the \$6.5 billion currently being spent on fees for payday loans sold by non-mainstream financial institutions—loans that could be widely sold at lower prices by banks and credit unions.¹¹ It is therefore critical to evaluate current alternative small dollar loan programs to build a business case for greater numbers of mainstream financial institutions to responsibly offer this product. This paper aims to further the growing body of work identifying and disseminating information about alternative small dollar loan programs, and begins to provide the necessary qualitative and quantitative data to make the business case for these products.

Comparison of Alternative Small Dollar Loans and Payday Loans

The majority of small dollar loan products currently available to consumers in Illinois and across the country are payday loans: short-term cash loans made to workers in advance of their paycheck, typically sold at rates as high as 25 to 30 times the average rate charged by credit cards, the closest alternative widely sold by most mainstream financial institutions.¹²

Nationwide, about \$40 billion in payday loans are purchased annually at one of the more than 22,894 establishments; nationally, about one out of every five neighborhoods now includes at least one payday loan business.¹³ Studies show that using a payday loan increases the likelihood that the borrower will fall behind on a credit card payment, be subject to eviction, will lose a bank account, face a utility cutoff, delay medical care, or file for bankruptcy.¹⁴

According to the Illinois Department of Financial and Professional Regulation (IDFPR), there were 521 licensees operating under the Payday Loan Reform Act and the Consumer Installment Loan Act in Illinois in 2008.¹⁵ Researchers put the total national costs to consumers for using a payday loan at \$4.2 billion annually.¹⁶ IDFPR found that during the period of February 2006 to December 2008, 1,194,582 payday loans were taken out by 204,205 consumers in Illinois—an average of 5.9 loans per consumer at an average annual percentage rate (APR) of 341%, representing a total advance amount of approximately \$424 million and advance fees of approximately \$65 million.¹⁷ According to the National Consumer Law Center, nationally, 90% of payday lending is generated by borrowers with five or more loans a year; and over 60% of payday lending business is generated by borrowers with 12 or more loans a year.¹⁸ Payday lenders depend on this repeat borrowing to make a profit; as one payday lender admitted, “You’ve got to get that customer in, work to turn him into a repetitive customer, long-term customer, because that’s really where the profitability is.”¹⁹

Researchers have also found that the business model of payday lenders derives not only from this high yield and volume, but also from the high origination costs resulting from the fixed cost of having a store location open for many hours per week and from the need to compensate for a high default loss rate.²⁰ The lack of competition from banks and credit unions, which have enough capital diversification to retail comparable products at lower prices but choose not to enter this market, also helps payday lenders generate profit.²¹ Table 1 compares the features of a typical payday loan with those of a typical alternative small dollar loan, depicted here as a composite of the product offering from the credit unions and banks included in this paper.