Testimony before the House of Representatives Committee on Financial Services
Sub-Committee on Consumer Protection and Financial Institutions
Hearing on: Ending Debt Traps in the Payday and Small Dollar Credit Industry
April 30, 2019 2:00 PM
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Chairman Meeks, Ranking Member Luetkemeyer, and Committee members: Thank you for allowing me the opportunity to share some thoughts and insights on the small dollar credit (SDC) industry and its impact on Americans' financial health. The Center for Financial Services Innovation (CFSI) is the leading authority on consumer financial health. We are a trusted resource for business leaders, policymakers, and innovators united in a mission to improve the financial health of their customers, employees, and communities. Through research, advisory services, measurement tools, and opportunities for cross-sector collaboration, we advance awareness, understanding and proven best practices in support of improved consumer financial health for all. Our largest initiatives include the Financial Solutions Lab and the U.S. Financial Health Pulse. The Financial Solutions Lab -- a partnership with JP Morgan Chase -- is a seed-stage fintech accelerator focused on advancing the financial health of low- and moderate-income (LMI) and historically disadvantaged consumers. The U.S. Financial Health Pulse is an annual snapshot of how Americans manage their financial lives with actionable insights to improve financial health.

Summary

With this written testimony, I intend to (1) discuss the sources of demand for SDC; (2) explore the features of responsible supply; (3) identify emerging sources of responsible supply; and (4) briefly discuss the most promising opportunity to improve SDC consumer outcomes.

As an authority on the financial health of Americans, CFSI has researched the consumer behaviors, products, and providers that comprise the SDC market. And we have supported and highlighted innovations in this market that are most consistent with advancing consumers' financial health.

Our research suggests that a variety of different needs and use cases underlie the demand for small-dollar credit and that many of them are symptomatic of one or more dimensions of poor financial health on the part of borrowers. Historically, payday lenders, auto title lenders, pawn shops, and other subprime lenders have dominated the provision of small-dollar loans. Many of the products they have offered are expensive, rarely underwritten, rely on cycles of continuous use, and harsh collection practices that both exploit and perpetuate borrowers' financial distress. Auto title loans are of particular concern because of the potential loss of a car in the event of default.

Understanding the nature of demand for such products should inform how providers can meet that demand responsibly—and the limits to their doing so. Short-term, small-dollar credit products must generate sufficient profit in order for providers to make them available to credit-worthy consumers who need them. The success of responsible products must be measured not simply by whether they meet demand, but by their potential to help users improve their financial health.

Consumer financial health and SDC demand

Like most other forms of credit liabilities that reside on consumers' balance sheets, demand for small-dollar credit is derived demand. Mortgage credit derives from consumers' needs and preferences for shelter; auto loans from needs and preferences for personalized transportation; student loans for human capital and credentials; and some credit card and installment credit for needs and preferences for purchases of large durable goods. For each of the above credit liabilities, a corresponding asset or future use value sits on the other side of the consumer's balance sheet.

The source of demand for most small-dollar credit diverges from the use cases described above. As the term "liquidity lending" implies, these loans are generally used to pay either for regular living expenses when the borrower has insufficient cash on hand to pay for them, unexpected or emergency expenses, or to displace another short-term liabilities, such as overdue bills or servicing of an existing debt.

According to the FDIC's 2017 National Survey of Unbanked and Underbanked Households, 19.7% of households surveyed had no mainstream credit in the past 12 months.[1] 6.9% of households used an alternative financial services form of credit (these include payday loans, refund anticipation loans, rent-to-own services, pawn shop loans, and auto title loans) in lieu of bank products.

[1] 2017 National Survey of Unbanked and Underbanked, Federal Deposit Insurance Corporation, October 2018.

Of that:

- 1.7% of households used payday loans
- 2.4% used refund anticipation loans
- 1.4% used rent to own
- 1.4% used pawn loans
- 1.4% used auto-title

The share of households with no mainstream credit varied substantially across socioeconomic and demographic groups. Lower-income households, less-educated households, black and Hispanic households, working-age disabled households, and foreign-born, noncitizen households were more likely not to have mainstream credit.

There is ample evidence to suggest that a large portion of American households face expenses for which they do not have sufficient cash on hand one or more times during the year. CFSI's Financial Diaries Project, which studied the day-to-day earnings and expenses of 235 LMI households over the course of a year, found that month-to-month spikes in expenses, coupled with income volatility associated with variable and uncertain work scheduling and employment insecurity, led expenses to exceed income in multiple months of the year.[2] These findings were further supported by the JP Morgan Chase Institute's seminal 2015 study on income volatility.[3] Separately, the Federal Reserve's Report on the Economic Well-Being of U.S. Households in 2017 found that "Four in 10 adults…would either borrow, sell something, or not be able to pay if faced with a $400 emergency expense."[4]

CFSI research has identified four primary drivers of demand for SDC[5]:

- **An unexpected expense** such as a car repair, medical bill, home repair, or help provided to family and friends. (32% of respondents)
- **Misaligned cash flow**, when income and expenses are mistimed due to income variability or expense management issues and borrowing is needed to pay recurring expenses such as utilities, rent, or groceries. (32% of respondents)
- Expenses that **regularly exceed income**. (30% of respondents)
- A **planned purchase** of a personal asset or paying off debt. (9% of respondents)

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[2] Rachel Schneider and Jonathan Morduch, Spikes and Dips: How Income Uncertainty Affects Households, CFSI and the Financial Access Initiative at New York University, October 2013.
[3] Weathering Volatility: Big Data on the Financial Ups and Downs of U.S. Individuals, JP Morgan Chase & Co. Institute, May 2015.
[4] Report on the Economic Well-Being of U.S. Households in 2017, Board of Governors of the Federal Reserve, May 2018.
[5] Know Your Borrower: The Four Needs Cases of Small-Dollar Credit Consumers, CFSI, December 2013.

Financial health lens

As stated earlier, the value of an SDC product should be measured by its ability to improve the financial health of the consumer. Unfortunately, too many traditional sources of SDC contribute to, rather than address, poor financial health.

CFSI defines financial health as having a day-to-day financial system that builds resiliency and enables people to pursue opportunities. We have identified eight key indicators of financial health that characterize how consumers spend, save, borrow, and plan for the future.[6] Consumers are financially healthy when they:

- Spend less than income
- Pay bills on time and in full
- Have sufficient living expenses in liquid savings
- Have sufficient long-term savings or assets
- Have a sustainable debt load
- Have a prime credit score
- Have appropriate insurance
- Plan ahead for expenses

When combined to provide an overall measure of consumers' financial health, these indicators can help business leaders, employers, policymakers, and innovators better understand how their actions are supporting improvements in financial health over time.

Viewed through the lens of consumer financial health, the primary use cases for SDC represent constrained choices and are indicative of poor financial health. While a short-term loan may manage an immediate symptom, use of SDC often fails to address the underlying causes and in some cases—particularly with sustained use—may worsen them.

For example:

- **Unexpected expense:** Using SDC to meet unexpected emergency expenses may reflect that a consumer does not have an adequate **cushion of liquid assets** (one key positive indicator of financial health) or does not carry **appropriate insurance** (another indicator) to cover emergency medical, auto, or home repairs.

- **Misaligned cash flow:** Volatility creates chronic mismatches between income and expenses requiring even larger liquidity cushions and that are increasingly difficult to

[6] Eight Ways to Measure Financial Health, CFSI, May 2016.

replenish. Building and maintaining such cushions involves **planning ahead** (another key indicator), while the use of credit to meet them may reflect a lack of planning.

- **Planned purchases:** Some types of credit are designed to facilitate large purchases cost-effectively spreading purchase costs over the life of the asset. However, these sources of credit are generally only accessible to consumers who have established **good credit scores** (another key indicator). Use of subprime, small-dollar credit for such purchases can be far more expensive and can reflect lack of access to prime credit and the presence of an unsustainable **debt load** (a negative indicator).

- **Expenses regularly exceed income:** No source of credit can sustainably address cash shortfalls that occur when a consumer chronically **spends more than they earn** (another negative indicator).

CFSI Compass Principles

In 2014, as part of CFSI's Compass Principles, we issued The Compass Guide to Small-Dollar Credit. We outline seven characteristics of small-dollar credit products that embrace inclusion, build trust, promote success, and create opportunity among borrowers.

A high-quality loan:

1. **Is made with high confidence in the borrower's ability to repay.** We advocate using the best available underwriting techniques to ensure a borrower's ability to repay without re-borrowing and while still meeting basic needs and financial obligations. We discourage reliance solely on collateral to assure repayment.

2. **Is structured to support repayment.** We encourage lenders to make closed-end loans that are fully amortizing and without prepayment penalties. We encourage lenders to strike a balance between making payment amounts affordable (including minimum payments on lines of credit) and minimizing cost over the length of the loan. We encourage products that get borrowers to pay their balances down to zero creating capacity for new credit when it is needed.

3. **Is priced to align profitability of the provider with success for the borrower.** We encourage lenders to reward positive repayment behavior by lowering costs and to avoid relying on penalty fees as profit drivers.

4. **Creates opportunities for upward mobility and greater financial health.** We encourage reporting to the major credit bureaus to help borrowers improve their credit

scores when they successfully repay. We also encourage institutions to combine SDC products with savings opportunities and incentives, helping borrowers improve their ability to manage future emergencies or cash shortfalls.

5. **Has transparent marketing, communications, and disclosures.** We encourage lenders to disclose the full cost of the loan to the borrower in simple, clear, and easy-to-understand language, with no hidden fees, industry jargon, or misleading information or fine print. This includes providing pricing information prior to the application. We discourage bundling of add-on products (such as credit insurance) that muddy the consumer's understanding of the full cost of the loan.

6. **Is accessible and convenient.** We encourage lenders to allow loan payments through multiple channels, such as Automated Clearing House (ACH), in-person, online, mobile, or via kiosk. Likewise, flexibility in loan applications and loan disbursements can help to increase access and improve the customer experience.

7. **Provides support and rights for borrowers.** We encourage lenders to ensure that borrowers can obtain customer support easily and are treated respectfully. This means assigning borrowers to individual relationship managers when servicing and collection issues arise. It means not using collections tactics that employ harassment or intimidation under any circumstances.

Note on the cost of credit

Concerns about both the charging of interest and the amount of interest being charged have deep religious, cultural, and legal roots. In the United States, these debates have revolved around a usury cap of 36% since the early 20th century. Many proponents reasonably argue that usury caps (such as those prevailing in some states and under the federal Military Lending Act (MLA)) provide an implicit incentive for institutions to make loans that borrowers have the ability to repay and to underwrite in ways that limit default risk levels that cover the cost of credit. Others validly argue that price caps, either explicitly imposed under usury laws or implicitly under the guise of safety and soundness concerns, limit lenders' ability to offer credit to consumers who pose a higher default risk—often those most in need of liquidity credit.

The true cost of a short-term depends heavily on the structure of the product, the length of time in debt, and the anticipated range of borrower outcomes. A two-week, $500 deposit advance, at a cost of $10 per $100 advanced, may seem relatively inexpensive at $50 if it avoids a loss of utilities or a car repossession. However, if the loan has a high probability of triggering an extended sequence of re-borrowing (i.e., six loans, over 12 weeks and a total cost of $300), the transparency and safety of the product is compromised. In contrast, a $500 closed-end, 90-day installment loan with an upfront cost of $12 per hundred has a higher price but it may have a lower probability of re-borrowing and an extended cycle of fees. Even a subprime credit card with a 36% APR may ultimately lead to a higher cost per use if the borrower carries a balance for a sustained period: a $500 cash advance on such a card, with the typical 3% advance fee and repaid only using minimum payments for the six months following use, would cost roughly $115.

CFSI recognizes that there is often a trade-off between cost and availability. We encourage policymakers to allow institutions to experiment along the cost and availability spectrum, including for products with pricing above 36% APR. Policymakers should focus their efforts around understanding whether a product improves consumer outcomes in a measurable and demonstrable way rather than just filling immediate demand or meeting compliance requirements.

Note on annualized percentage rate (APR)

APR was created as a tool for comparison shopping of similar credit products (e.g. 30-year fixed mortgages). The APR calculation does allow the consumer the ability to compare real world trade-offs such as a payday loan versus paying rent. While a standard measurement of cost is essential for a transparent market, APR is not that tool for the SDC market.

An annualized percentage rate (APR) is calculated as follows:

$$\mathrm{APR} = \left(\left(\frac{\frac{\mathrm{Fees+Interest}}{\mathrm{Principal}}}{n} \right) \times 365 \right) \times 100$$

where:

$\mathrm{Interest} = \mathrm{Total\ interest\ paid\ over\ life\ of\ the\ loan}$

$\mathrm{Principal} = \mathrm{Loan\ amount}$

$n = \mathrm{Number\ of\ days\ in\ loan\ term}$

As *n* (the number of days) approaches zero the APR calculation becomes less helpful as a true measure of the cost of credit.

Innovations in responsible SDC

The broader consumer finance industry is in the midst of dramatic change, as a result of the ever-increasing speed of technological innovation and the broadening and deepening of data availability. Fintech start-ups and innovative incumbents are developing and testing products that have the potential to meet the financial needs of underserved households.

Some of the most important developments include:

- **Early wage access:** Several companies, including Even, PayActiv, and FlexWage allow a consumer to obtain early access to wages already earned. In some cases, these services are offered through employers as an employee benefit. By tying repayment automatically to deductions from upcoming paychecks, the advances minimize risk of default and thus dramatically lower cost. In early experiments both uptake and employee satisfaction have been high; and there is evidence of employer benefit in the form of lower employee turnover.[7]

  Allowing early access to wages can help consumers manage needs frequently filled by SDC products, particularly mismatches in income and expense timing. At present, many early wage access products share the same structural weakness of payday loans and other single-payment forms of credit: the potential to leave borrowers short on the next payday possibly leading to a high degree of repeat use. However, providers and their employer partners could address this potential harm by allowing wage advances to be repaid in installments over multiple pay periods.

  Ideally, employers and their payroll service providers will find solutions that allow employees to receive their earned wages without the involvement of a financial services provider.

- **Overdraft insurance:** At least three companies (Dave, Oportun, and Brigit) have launched subscription services that advance small amounts of credit specifically to enable users to avoid overdrawing their accounts. Advances are automatically triggered when checking account balances fall below a pre-set threshold. Underwriting based on the consumer's cash flow data is made possible when users provide the services permission to view their daily account balances and transaction histories. Savings to consumers appear substantial as the monthly subscription fees and voluntary payments received by these providers are far less than what users would otherwise pay in overdraft fees.

- **Cash flow-based underwriting:** A variety of non-bank lenders and credit bureaus are pioneering the use of consumers' deposit and spending patterns to assess creditworthiness. Some are applying these techniques to lower default risks and costs in the small-dollar credit arena. The data are made available with the customer's permission

[7] Todd H. Baker, FinTech Alternatives to Short-Term Small- Dollar Credit: Helping Low-Income Working Families Escape the High-Cost Lending Trap, Mossavar-Rahmani Center for Business and Government, at the Harvard Kennedy School, May 2017. See also "Walmart's pay-advance app Even used by 200,000 employees," American Banker, July 19, 2018.

through aggregators, who are increasingly using secure Automatic Program Interfaces (APIs) to obtain data.

Cash flow-based underwriters include both some early wage access providers and overdraft insurance providers. Banks already possess account deposit and spending history on their customers and are readily positioned to use this asset in underwriting their own credit products.

- **Advanced liquidity management tools:** The last decade has witnessed a proliferation of digital tools that help consumers better manage their day-to-day spending and thereby help avoid cash shortfalls. These can effectively reduce demand for small-dollar credit while addressing the daily challenges of managing limited budgets. These tools have been introduced as both stand-alone fintech tools and as account features by a growing number of banks.

  The tools that are experiencing the greatest uptake by consumers include:

  - **Income earmarking,** which allocates portions of incoming earnings to expected recurring obligations before they can be used for discretionary spending;

  - **Digital registers,** which use automated intelligence to predict automated bill payments and other recurring transactions and, accordingly, adjusting consumers' discretionary spending balances;

  - **Automated savings,** which operate in the background of consumers' daily financial lives to build cushions of liquid assets that can be drawn on in emergencies and automatically replenished.

- **Bank-issued SDC:** In their roles as hosts to our national payment systems and providers of deposit and transaction accounts, banks have unique insights into the day-to-day earning and spending—and ultimately, the financial health—of their customers. They are well-positioned to offer solutions to financially vulnerable consumers to improve and maintain their financial health. SDC products can be a part of these offerings.

  Banks are also well-positioned to lower the risk and cost of extending small-dollar credit. Lending to existing customers can largely eliminate fraud risk, while banks' insight into customers' earning and spending behavior can enable them to assess default risk and extend credit to consumers whose credit scores underestimate their ability to repay.

Separately, banks' ability to debit repayments from consumers' incoming deposits can reduce their default risk.

However, permission to collect payments via auto-debit should not be made a condition for extending credit. Likewise, loss of one's checking account should never be made a consequence of non-payment of credit.

CFSI supports the efforts of the Office of the Comptroller of the Currency (OCC), the National Credit Union Administration (NCUA), and the Federal Deposit Insurance Corporation (FDIC) to build a framework that spurs the growth of another source of responsible SDC.

The potential for consumers to better manage their short-term liquidity needs, through both better forms of credit and new spending management and savings tools, has never been greater.

Note on bank-issued SDC

Last year CFSI, the Pew Charitable Trusts, and other non-profits worked with U.S. Bank to design a responsible SDC product. In September of 2018, U.S. Bank introduced an installment loan that is repaid over three months, with monthly payments set at 5% of a customer's monthly income. Whereas a traditional $400 payday loan repaid over three months costs an average of $350, the U.S. Bank product offers the same credit that serves deep subprime consumers for $48 -- representing an 86% savings for consumers.[8] Not only does this product represent a significant improvement for consumers but is a model of how different stakeholders collaborate on innovative solutions. Lastly, this product and other bank-issued SDC will require extensive research to understand the impact on consumer outcomes.

Current policy reforms

Following the passage of the Dodd-Frank Act the Consumer Financial Protection Bureau (CFPB) undertook almost a decade of robust research and rulemaking activity. While we, like most other stakeholders, had specific proposals that conflicted with the final rule we applaud the integrity of the CFPB's efforts.[9] The rule was narrowly tailored to address the most urgent issues in SDC -- short-term balloon payment loans. Importantly, the CFPB's final rule created space for innovation around loans greater than 45 days in duration. The SDC market has been incorporating the CFPB's requirements and is providing a range of products across various price points and durations.[10] We are dismayed to see an unjustified abandonment of core provisions of

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[8] Nick Bourke, American Banker, "Momentum is Building for Small-Dollar Loans," Sept. 12, 2018

[9] CFSI's comment letter to the CFPB on the "Payday, Vehicle Title, and Certain High-Cost Installment Loans," notice of proposed rulemaking, July 22, 2016.

[10] State Laws Put Installment Loan Borrowers at Risk, Pew Charitable Trusts, October 2018.

the final rule -- particularly the ability to repay requirement which already exists with mortgages, credit cards, and the income-driven repayment programs for federal student loans. Our forthcoming comment letter in response the CFPB's recission RFI will discuss our concerns in more detail.

Conclusion

CFSI recognizes that SDC products often treat the symptoms of consumer credit issues rather than the cause of those issues. Financial products are not and never will be a substitute for policies that ensure equal opportunity for all Americans. The U.S. needs policies that mitigate the need for SDC, such as livable wages, access to affordable healthcare, dependable work schedules, and family and sick leave policies for hourly and contingent workers. We recognize these policies are not within the scope of this hearing, but they will be important elements in addressing the true drivers of SDC demand.