Small-Dollar Credit: Protecting Consumers and Fostering Innovation

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When household emergencies strike or there's not enough in the bank to make it to the next paycheck, some families turn to small-dollar credit—small loans from alternative financial service (AFS) providers, such as payday lenders or pawnshops, or from mainstream banks or credit unions. Credit can be a lifeline when money is tight, but some credit products and practices risk leaving consumers trapped in a cycle of debt. Financial regulations can help protect consumers from harmful practices, but their benefits must be weighed against their potential to drive potential innovators from the market, unnecessarily restrict consumers' access to credit, or, worse, push consumers toward other harmful products.

In October 2014, the Urban Institute convened researchers and state and federal regulators to discuss what is known—and unknown—about the small-dollar credit market to help inform efforts to protect consumers and enable innovation toward affordable, accessible, and mobility-enhancing small-dollar credit products. This brief summarizes the convening discussion. Participants discussed the diversity of small-dollar credit consumers and what kinds of product features work best for consumers. They gave insights into existing experiences with regulation and weighed in on potential effects to consider when crafting regulation. Participants also raised research questions (summarized in appendix A) that could be studied to increase understanding of the complex and shifting small-dollar credit marketplace. This brief complements an earlier brief summarizing a related convening with researchers, credit union experts, and bank representatives (McKernan, Ratcliffe, and Quakenbush 2014).

Consumer Experiences and Needs

Observational and empirical study has shed light on the instability faced by low- and moderate-income households, the groups most likely to turn to the alternative financial sector to meet credit needs (table 1). Their financial lives are characterized by a complex mix of products and strategies, and some apprehension toward the mainstream financial sector. A subset of small-dollar credit consumers has exhausted available credit or fallen behind on their debts.

TABLE 1

Consumer Needs and Experiences

Consumer experiences	Examples
Volatile circumstances	Income, expenses, and household composition can change wildly from month to month (Morduch and Schneider 2013). Volatility points to need for flexibility (McKernan, Ratcliffe, and Quakenbush 2014).
Reliance on formal and informal tools to manage finances	Borrowing from friends and family, using credit cards, overdrawing checking accounts, and strategically paying bills late (Morduch, Ogden, and Schneider 2014).
Previous failures with traditional credit	In one study, 59 percent of payday-loan applicants from one provider had a credit card. The median cardholder had overdrawn his or her credit limit, and 69 percent of payday-loan applicants with credit cards had delinquent card accounts (Bhutta, Skiba, and Tobacman 2013).
Diverse credit uses	Consumers turn to small-dollar credit to cover emergency expenses (32 percent), to cover living expenses before their next paycheck arrives (32 percent), and for planned purchases (9 percent). Some also use small-dollar credit for chronic shortfalls, where credit is not appropriate (30 percent, Bianchi and Levy 2013).

Volatility can be a fact of life for low- and moderate-income households (Morduch and Schneider 2013). Income, expenses, and household composition can change considerably from month to month. Household income comes from various sources, including formal and informal work, public support, and tax credits. Though annual household income may adequately cover annual expenses, in any particular month the loss of a job, the exit of an earner from the household, or a costly home repair can destabilize a family's finances. Qualitative research on very low income households reveals a strong desire for stability among this population, with many reporting they want just "one good-paying job" to stabilize their finances (NFCDCU 2015).

Amid this instability, low- and moderate-income households rely on formal and informal tools and complex strategies to manage their financial lives, ranging from credit cards to borrowing from friends and family (Morduch, Ogden, and Schneider 2014). Among 244 households across five states participating in the US Financial Diaries survey, 36 percent of households reported borrowing from friends and family, and half of these informal loans were between $101 and $500 (Morduch, Ogden, and Schneider 2014).

Financial management can also include strategic behavior, such as choosing to pay certain bills late or overdrawing a checking account as a form of quick credit. Consumer Financial Protection Bureau analysis of checking account data shows that about 45 percent of account holders opting into overdraft protection incur overdraft fees, with about 30 percent overdrawing more than three times a year (Bakker, Kelly, Leary, and Nagypál 2014). Among US Financial Diaries households, 46 percent of those with checking accounts overdrew at least once in the past year, and nearly a quarter had two or more overdrafts (US Financial Diaries 2014; Morduch 2014). Late bill payment was as common as payday loans, with 9 percent of participants reporting that they paid bills one or more weeks late.

Consumers of alternative financial services are sometimes thought to have no or limited credit histories or credit scores. But Bhutta, Skiba, and Tobacman's (2012) analysis of payday-loan applicant data from a major lender shows that about 59 percent of applicants had at least one credit card and that the median card balance among those with credit cards was above the median credit limit. Additionally, 69 percent of payday-loan applicants with credit cards had delinquent card accounts. These findings suggest that many small-dollar credit consumers have experience with the mainstream financial sector, but that they have exhausted available credit, or fallen behind or defaulted on their obligations.

One participant in the convening described a series of focus groups of very low income consumers—those with less than $20,000 in income—that revealed mistrust and discouragement with the mainstream financial sector (NFCDCU 2015). Members of this population report feeling less judged by alternative financial service providers. Their feelings were sometimes related to a sense that participation in mainstream services, such as bank account ownership, was out of reach. They saw such services as a "step up" to be achieved after their situation stabilized, rather than as something they could attain now.

Regulatory Experiences and Challenges

Federal and state financial regulators are tasked with protecting consumers from predatory practices. Ideally, consumer protection measures would allow access to affordable credit products for creditworthy consumers and space for new, consumer-friendly innovations to enter the marketplace. Sound research on consumer needs and what approaches work best, along with a stronger understanding of how regulations affect the business models of providers, can inform policymakers and innovators in pursuit of these goals.

State legislatures and regulators have used various tools to regulate small dollar-credit (table 2). Approaches include imposing caps on fees and interest rates charged by providers, limiting the number of loans consumers can take out over a period of time or the number of times an existing loan can be rolled over, requiring transparent disclosure of the price (e.g., annual percentage rate, APR) and terms of the loan, and mandating the availability of repayment in installments rather than as a lump sum.

TABLE 2

State Approaches to Regulating Small-Dollar Credit

Regulatory tool	Observations and examples
Setting fee and rate caps	Lenders tend to charge the maximum fee in each state. States without fee caps have the highest cost of credit (Pew Charitable Trusts 2014a).
Licensing lenders	A large number of complaints arise from unlicensed lenders that evade regulations. This is especially true of online lenders (Pew Charitable Trusts 2014b). States send desist and refrain orders to unlicensed lenders, though some such lenders simply relocate or move online.
Defining illegal loans and making them uncollectable	The Florida and Illinois legislatures passed laws making payday loans from unlicensed lenders uncollectible.
Setting consumer loan limits and enforcing them through state databases	Provides oversight of licensed lenders, but consumers may still borrow from unlicensed and online payday lenders not tracked in the database.
Requiring installment payments	Some small single-product lenders shut down, driving more volume to larger multiproduct lenders (Pew Charitable Trusts 2013).
Requiring disclosures	There is disagreement on whether APR is the appropriate measure for disclosure. Consumers may not understand its meaning, and some fees may not be included in the APR.

To enforce these provisions, some states have created licensing requirements for lenders. In some cases, states track loans via statewide databases to, for example, ensure that consumers do not evade loan limitations by borrowing from multiple lenders. States may shut down unlicensed lenders or deem their loans void and uncollectable (Florida and Illinois, for example, each passed laws establishing the latter in recent years). Legal action can be taken against lenders or debt collection agencies that engage in abusive debt collection practices.

The growing market for online loans is a relatively new development. Online payday lenders generate about 9 out of 10 payday-loan complaints to the Better Business Bureau (Pew Charitable Trusts 2014b). These complaints are often about unlicensed lenders who engage in fraud, including unauthorized transactions, and aggressive collection practices such as threats to contact employers or report delinquent borrowers to police. These unlicensed lenders are difficult for regulators to shut down because they can operate across state lines and even overseas.

Most of the approaches used by states were discussed in the context of payday loans; however, researchers stressed that it is important for regulators to consider the possibility that restricting one product could lead to the substitution of other high-cost credit products, such as auto-title or pawn loans. Regulation should take a broad view of the small-dollar credit market and other alternative financial services.

Regulation's Potential Impacts on the Marketplace and Consumer Well-Being

Participants noted that the design of regulation can affect consumers' access to credit, the prices they pay, the level and kinds of innovation and products on the market, and the overall market structure for financial services (table 3). A better understanding of the business models and profitability of current providers, from storefronts to credit unions and banks, can improve regulation and anticipate market and consumer welfare outcomes. Researchers suggested that regulators can draw lessons from the experiences of states that change their small-dollar credit regulations, as in the recent case of Colorado.

TABLE 3

Potential Market Impacts of Small-Dollar Credit Regulation

Market impacts	Examples
Innovation	Both good and bad: some innovations are intended to evade new regulations, but regulation can also encourage consumer-friendly products.
Credit availability	Restrictions can limit access to credit for some households, either through the removal of credit products from the market or stricter underwriting processes.
Price change	Credit may become more or less expensive to consumers, and some business models might not profit below certain price caps.
Market structure	Changes enacted in Colorado in 2010 led to consolidation of the payday-loan market. About half of payday-loan storefronts closed, with the number of borrowers falling by only 15 percent. Stores that remained were disproportionately chain stores offering multiple AFS products (Pew Charitable Trusts 2013).
Substitution and complementarity	Will consumers substitute one credit product for another if one is restricted? Does consolidation of the market to multiproduct chain stores promote the use of other AFS products?

Research on small-dollar credit focuses largely on consumers; less is understood about providers, their business models, and the competitiveness of the credit marketplace. Evidence suggests that the sector as a whole is not especially profitable and relies on volume and strategic placement of stores for steady business (Flannery and Samolyk 2005; Skiba and Tobacman 2007). Brick-and-mortar lenders (payday, pawn, and auto title) face considerable overhead costs in maintaining storefronts, paying staff, marketing, and losses from defaults. Auto-title stores tend to have low volume, and the high cost of repossession leads to relatively low repossession rates in many states (Hawkins 2012). Online retailers face fewer physical overhead costs, but higher costs in marketing and acquiring customers. In addition, online loss rates are higher, leading to higher loan prices and higher rejection rates for loan applicants (Pew Charitable Trusts 2014b).

In states with caps on APRs, major lenders tend to price payday loans at or near the cap, provided they can profitably operate within the limit. Meanwhile, higher rates prevail in states without rate caps (Pew Charitable Trusts 2014a). Payday lenders generally do not operate in states with a 36 percent APR cap (a cap widely promoted by advocates of anti-usury laws); this suggests that many current business models cannot succeed at this interest rate (Campbell, Jackson, Madrian, and Tufano 2011; Pew Charitable Trusts 2014a).

A 2010 Colorado law requiring low, amortizing installments instead of lump-sum repayment reshaped the small-loan market in the state. About half of payday-loan storefronts in the state closed, though most consumers still had access to at least one nearby storefront after the reform. The stores that survived tended to be chain stores that offered other financial services such as check cashing and bill payment in addition to small loans, while single-product mom-and-pop stores shut down. There was a 15 percent drop in the number of borrowers after the law was enacted, though the reason for this is unclear. In addition, the average APR paid by borrowers declined from 319 percent to 129 percent (Pew Charitable Trusts 2013).

Policy Challenges

Policymakers face challenges in designing legislation and regulation that protect consumers and leave room for innovators (table 4). Focusing on narrow product categories or practices can simply shift undesired behavior to similar products or practices that keep the letter but not the intent of the law. To avoid regulatory "whack-a-mole," policymakers must look across multiple AFS products to ensure that policies will have the intended effects.

Regulators can only act within their existing legal mandates to protect consumers and maintain the safety and soundness of the financial sector. For bigger market reforms, legislative action will be required. In some states, credit laws have not been updated for a very long time. This creates challenges for regulators attempting to keep pace with emerging technologies, products, and business models.

New rules can increase costs for providers and narrow profitability. When this happens, the small-dollar credit industry may shift toward larger chain lenders, as smaller mom-and-pop stores seem less able to absorb the new costs. McKernan, Ratcliffe, and Kuehn (2013) cite anecdotal evidence of this shift in the California rent-to-own market after the imposition of price caps. They also note that lenders may be less willing to serve riskier (higher-cost) borrowers when prices are capped. As discussed earlier, larger stores offering multiple AFS products were better able to survive after new rules were implemented in Colorado. How these changes affect consumers and market competition is unclear.

Input from researchers and providers at early stages of policy development can assist in ensuring that regulations do not impose unnecessary restrictions or stifle positive innovation. State regulators noted that they often lack sufficient staff to conduct major research, so comments from outside researchers and stakeholders can be helpful.

TABLE 4

Regulator Challenges

Regulator challenges	Examples
Balancing consumer protection with product innovation and access to credit	Pilots and safe harbors for innovators might give businesses a chance to try new product approaches and evaluate their effects before taking them to scale.
Avoiding regulatory "whack-a-mole"	Restricting access to one product might drive consumers to substitute other harmful products.
Changing technology	Technology can change faster than the law. Regulators can work with new entrepreneurs to make sure new products fit within the regulatory framework.
Understanding stakeholder needs and effects of new laws and regulations	Regulators invite comments from researchers and providers when considering rule changes, yet often don't receive feedback.
Understanding the market for products that are both safe and viable	Some evidence suggests that small-dollar credit products are not highly profitable and rely on volume, and that many consumers in this space have failed with traditional credit cards. There is a need to better understand providers' business models and the drivers of credit success (and failure) for consumers.
Working within existing regulation	Rule-writing and enforcement must be done within the boundaries of existing consumer credit law, which in some states hasn't been updated in several years.

Given evidence of limited profitability and many consumers' negative experiences with credit cards, some participants questioned how much room exists in the market for products that are both safe for consumers and viable for businesses. Both regulator and providers need a better understanding of the drivers of consumer success and failure with credit, more insight into provider business models, and more information about emerging technologies that can make new products or practices possible.

Pilots and safe harbors for products that meet certain guidelines are one way to help innovators experiment with improved products and business models. The National Credit Union Administration's payday alternative loan program enables credit unions to experiment with small loans with more affordable terms than typical payday loans. The program, which has generated a number of pilot products, allows for loan amounts between $200 and $1,000 with terms between one and six months, with a maximum APR of 28 percent, limited application fees, and no rollovers. A number of the pilot products leverage insights from behavioral economics to ensure successful repayment and include requirements that customers build savings to cover future expenses (though scalability is a concern for some of these products).

Conclusion

The diverse and often dynamic situations small-dollar credit consumers face challenge both regulators and financial service providers who aim to be responsive to these needs. For regulators, this means being mindful that actions that restrict consumers' access to credit can potentially disrupt their lives. Researchers and regulators at the convening agreed that the demand for credit among this population segment is unlikely to dissipate. Most participants felt that if current products are substantially restricted, workable alternatives should be found.

Providers see a market for small-dollar credit products and services. This market can include a suite of both credit and noncredit solutions. Consumers turn to credit for various reasons: as a temporary bridge until payday, to cover emergency expenses, to make large planned purchases, and—inappropriately—to mask chronic shortfalls in income (Bianchi and Levy 2013). Building trust among consumers who may view mainstream financial institutions with suspicion will also be a critical part of serving this population (Center for Financial Services Innovation 2014).

The volatility households experience points to a need for flexibility when it comes to repaying even small loans, such as allowing for small and variable repayment amounts rather than relying exclusively on rigid fixed installments or balloon-style payments (McKernan, Ratcliffe, and Quakenbush 2014). Households with tight budgets can typically set aside only a small share of their monthly income for repaying debt (Pew Charitable Trusts 2013). One participant questioned whether installment payments are the best option given such volatility.

While recent research and pilot programs have shed light on the small-dollar credit market and the lives of consumers, both researchers and regulators raised numerous questions that merit further research (appendix B). These questions relate to more information on how consumers manage their financial lives and cope with financial emergencies, the market structure of the alternative financial services industry, and the effects of different regulatory tools on consumer well-being.

Appendix A. Research Questions

During the roundtable, participants identified several questions warranting research to help better inform small-dollar credit product design and regulation. This appendix provides a list of many of these questions.

Consumer Behavior and Experiences

- How often is credit used to repay other debt?
- How common are hardship withdrawals from retirement accounts among low- and moderate-income consumers?
- Why do some consumers fail with credit cards? In theory, monthly credit card payments can be close to 5 percent of household income, one threshold proposed for the affordability of installment loans (Pew Charitable Trusts 2013). Yet close to 70 percent of payday-loan applicants with credit cards in Bhutta, Skiba, and Tobacman (2012) had delinquent accounts, and the median cardholder balance exceeded the median cardholder credit limit.
- Were cardholders in Bhutta, Skiba, and Tobacman (2012) past their credit limits because they maxed out their credit cards, or because their credit lines were reduced?
- Where do consumers who are denied credit turn? Do they go to friends and relatives, or to other substitutes for credit? What other substitutes do consumers have access to?
- How do consumers with high income volatility handle up moments? Do they use tax refunds to pay off debts?
- Do credit unions' customers differ from other consumers in ways that would make them more successful with or open to credit products?
- What are the needs of consumers who currently use small-dollar credit? When is credit, as opposed to other products or interventions (e.g., financial coaching, other financial tools, public assistance), the right answer for consumers? How large should consumers' savings buffers be?
- Auto-title loan dealers often market their products as one-month loans, but 80 percent of borrowers predict that they will not be able to repay the loan within one month. Data from Texas show that only 27 percent of borrowers in the state completely repay such loans in one month, and nearly half of consumers require four months or longer (Fritzdixon, Hawkins, and Skiba 2014). Should researchers and policymakers be concerned about the disconnect between the marketing of the loans and consumers' expectations?

Industry Structure and Product Design

- How competitive are small-dollar credit markets? Do providers compete on price? On service?
- How much does payday lending cost? What is the break-even point for the business model? How much room is there for viable and safe products?
- What is the value of local, storefront, stand-alone businesses, and how do we distill what is important about them from what is not?
- Does industry consolidation toward fewer stores offering multiple products make consumers better or worse off?
- What are the problems associated with current small-dollar credit products?

Effects of Regulation

- A more extensive evaluation of the effects of Colorado's payday-loan reforms could shed light on their impacts on consumer welfare. Why was there a 15 percent drop in the number of borrowers after the law changed? Are consumers better off spending more days of the year in debt on average (148 days before the law versus 227 days after the law)?
- Do consumers substitute other credit products when one type of product is restricted? Do they borrow online when credit from brick-and-mortar stores is less available or to avoid loan registries?

Appendix B. Roundtable Participants

State Regulators

Jedd Bellman, Maryland Office of Financial Regulation
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