**United States House of Representatives**
**Subcommittee on Financial Institutions and Consumer Credit**

*Hearing on:*

# Short-term, Small-Dollar Lending: The CFPB's Assault on Access to Credit and Trampling of State and Tribal Sovereignty

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Thursday, February 11, 2016

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Statement for the Record

by the

American Financial Services Association

Good Afternoon, Mr. Chairman, Ranking Member Clay, and Members of the Subcommittee. My name is Kelvin Simmons I am here today on behalf of the American Financial Services Association (AFSA) and the millions of traditional installment loan (TIL) customers that AFSA's member companies have served over the last 100 years.

Thank you very much for this opportunity to talk to you today about the Consumer Financial Protection Bureau's (Bureau) proposal for small-dollar loans and the impact that it will have on deserving consumers.

I ask that my full statement be submitted for the record so I can focus on three basic issues: (1) the need for small-dollar credit; (2) the fact that depository institutions are not equipped to address that need; and (3) the demonstrated ability of traditional installment lenders to offer safe and affordable access to small-dollar loans. This ability has been recognized by the Center for Financial Services Innovation, the National Black Caucus of State Legislators (NBCSL) and the National Hispanic Caucus of State Legislators. But first, let me paint a picture of my own experience and how I see the issue from the perspective of the community where I was born and raised – Kansas City, Missouri.

I am a former state director of economic development in Missouri. During my tenure as the director, the state's banks, credit unions and financial services divisions were under my executive authority. I was President/CEO of one of the largest community development corporations in Missouri and I was twice elected to the Kansas City Council in the very community where I was born and raised. The zip code where I was born and raised (64130) lies in Missouri's 5th Congressional District. My parents and I lived and owned homes in that zip code for over 50 years.

A study done between 2006 – 2012 by Dr. Rickey Keys for NBCSL in key urban cities across the United States, including Kansas City, showed that in that same zip code there were no banks, one credit union, a substantial numbers of check cashing outlets, and a significant number of payday loans and title loan stores. There were <u>no</u> locations that offered a choice for safe, reliable and affordable small-dollar loans. I characterized this as living in a community that had a financial services desert.

To further illustrate my financial services desert point, I served as Commissioner of Administration for the state of Missouri from 2009 – 2012. In that role, I had dual signatory authority with the Missouri State Treasurer to issue all checks on behalf of the state of Missouri. My name appeared on every check issued by the state. Even though my name appeared on all the state checks, there was not a bank where I could deposit that check in my hometown zip code.

In that same zip code, the average credit score was 606, which meant it was harder to obtain credit for car loans, mortgages, and items for which credit was needed. As you may have concluded, a number of citizens in this community were unbanked or underbanked. It is an understatement to say that in a financial services desert it is very difficult to obtain safe and affordable small-dollar loan products. It is concerning because it is inevitable that a car will break down, children will need school supplies, and emergencies will happen. The need for a safe, affordable small-dollar loan product is significant.

Last year in Missouri, there were over two million small-dollar loans made to Missouri citizens. Missouri has a population of just over five million people. The need is definitely demonstrated. These loans come in a variety of products, but after reviewing a number of those products, I believe one of the safest and most affordable small-dollar loan products is a TIL. I fear that if the TILs are not available because they become harder to obtain, the community will struggle with more predatory products or be left with no choices at all. This could be an unintended consequence to a well-meaning proposal.

I believe that there is a very obvious need that my former community and others like it have for high-quality, small-dollar credit products. The national need has been recognized by the Director of the Bureau, Richard Cordray, who testified last fall about preserving the ability of installment lenders and others to continue to make responsible loan products. Additionally the Federal Deposit Insurance Corporation (FDIC) undertook a pilot program to get banks to lend in this space.

However, despite years of effort, the FDIC has found that banks do not see small-dollar loans as a profitable business line. To illustrate my point even further, Liberty Bank, one of the nation's largest African-American owned banks, and one which has a location in Kansas City, participated in the FDIC pilot program. I worked with Liberty Bank in Kansas City and they do a terrific job of lending in the community. But in the pilot program, they concluded that despite their desire to meet the small-dollar lending need, it was difficult to make those loans work over time without some form of a subsidy. I commend them for their attempts to work with their customers because this is difficult.

So the obvious question is – who is best suited to meet the need for high-quality, small-dollar loans? The answer is traditional installment lenders making TILs. What are TILs? TILs are fixed-rate, fully-amortizing, small-dollar loans repaid in equal monthly payments or installments. The industry average loan is for $1,500. The average monthly payment is $120 and the average term is 15 months. The average loan amount, monthly payment, and average term vary by lender. TILs are affordable to each borrower's monthly budget. They are "plain vanilla" loans with transparent, easy-to-understand terms, due dates and payment amounts. Installment lenders underwrite loans based on consumers' credit reports and other factors. At the time of origination, each and every loan is made with the highest confidence and expectation that it will be paid back in full and on time.

As I mentioned earlier, the Center for Financial Services Innovation has published a Compass Guide to Small Dollar Credit that I have included in my full statement, which outlines high quality characteristics that reflect TILs.

A high-quality small-dollar loan as one that:

1. Is made with a high confidence in the borrower's ability to repay;
2. Is structured to support repayment;
3. Is priced to align profitability for the provider with success for the borrower;
4. Creates opportunities for upward mobility and greater financial health;

5. Has transparent marketing, communications, and disclosures;
6. Is accessible and convenient; and
7. Provides support and rights for borrowers.

In 2014, the Missouri legislature passed SB 866 to separate and distinguish TILs as a high quality product distinct from payday and title loans. In December of 2015, the NBCSL adopted a resolution, also in my full statement, endorsing the development of responsibly underwritten small-dollar installment loans. The resolution identifies the key structural qualities of safe and affordable loans as being a schedule for repayment in substantially equal installments, and the lenders' assessment of the borrower's stability, ability, and willingness to repay.

The resolution also addresses the issue of the cost of the loan, pointing out that the annual percentage rate (APR), a required disclosure to borrowers, is not always the best indicator of actual cost. It affirms the importance of ensuring consumers' access to low-cost, rather than low-rate, loans. Historically, APR rate caps have been a favored means of regulation, despite not differentiating between loan types.

The resolution states that lenders should examine factors such as a borrower's credit history, monthly disposable income available to service the debt, employment and existing debt as a condition of making a loan. It also recommends that lenders be community-based, licensed and audited by the state, and actively participate in community and charitable activities, particularly those relating to financial literacy.

The Bureau's stated objective of the small-dollar proposal is to protect consumers from the harmful characteristics of payday, title loans, and similar short-term loans. These types of loans all have repayment schedules that are typically three months or less consisting of one to three payments and may include a balloon payment.

We understand the Bureau's concerns about these loans. We agree that some loans may trap borrowers in a cycle of debt. And we agree that the Bureau should enact common sense protections to ensure that consumers have access to credit that helps, not harms them. As I have pointed out, TILs are safe and affordable loans that serve many purposes, including helping consumers out of debt traps.

Unfortunately, the proposal is so broad that it covers all payday, title loans, and many TILs. How are TILs different from payday loans? Unlike payday loans, TILs do not have prepayment penalties or large, one-time balloon payments. They are fully-amortizing loans. TILs are paid off through equal monthly payments of principal and interest that provide a clear roadmap out of debt.

If the Bureau does not limit the rulemaking to payday and title loans, lenders may choose not to make loans above 36% all-in APR. This will cut-off access to loans below $4,000 for two main reasons.

First, traditional installment lenders have worked tirelessly to distinguish themselves from payday lenders. They cannot afford the reputational risk of being associated with payday lenders.

To avoid being seen as anything resembling payday or title, they may choose not to offer a product that is labeled by the Bureau as a "covered loan" under a payday and title rule. This will leave consumers with limited options. Consumers will have to borrow more to stay under 36% all-in APR set by the Bureau, provided they qualify. Or, more likely, consumers will go to disreputable "lenders" (or loan sharks) to get the money they need.

The second reason that lenders may decide against offering covered loans is that they simply will not be able to make small-dollar loans, especially with onerous and unnecessary income verification standards, at 36% all-in APR. According to a study done by three academics using industry data, in order to make a break-even loan at 36% APR, the loan would have to be made for at least $2,600. For a loan to be made profitably at 36% all-in APR, the loan would have to be for around $4,000. In a Bureau field hearing on military lending, almost all the panelists told Bureau staff that it was impossible to make such loans. As I mentioned previously, the FDIC pilot study on small-dollar loans also showed that banks could only make these loans as loss-leaders.

In conclusion, I hope that I have shown the members of the subcommittee that: (1) there is a great need for high-quality, small-dollar loans in many communities, like the one in which I was raised; (2) TILs meet the definition of high-quality, small-dollar loans and are meeting the need in many of these communities; and (3) most importantly, the Bureau must be careful to preserve the ability of installment lenders to offer these responsible loan products as Director Cordray indicated in his testimony before this committee last September.

Thank you and I look forward to answering any questions the Subcommittee members may have.

# APPENDIX I

# BUSINESS AND ECONOMIC DEVELOPMENT

Resolution BED-16-21

## A RESOLUTION PROMOTING SAFE AND AFFORDABLE LENDING PRACTICES

WHEREAS, the National Black Caucus of State Legislators (NBCSL) has always been committed to financial empowerment through improved access to capital as well as a marketplace that offers safe and affordable lending products and services;

WHEREAS, in 1998, the United Nations defined poverty as the lack of access to certain essential goods and services, including access to credit;

WHEREAS, the need for small-dollar closed end credit exists in every community throughout the country;

WHEREAS, not all loan types are equally safe and affordable, and the structure of certain loans significantly increases the likelihood of borrowers falling into a cycle of debt;

WHEREAS, responsibly structured credit is essential to support a household's ability to save, build a sound credit history, and facilitate crucial investments that can provide a foundation for other wealth-building activities;

WHEREAS, the key structural qualities of closed end loans that are safe and affordable are that the lender makes a good faith effort to assess the borrower's ability to repay the loan and that the loan is repayable in substantially equal installments, with no balloon payments;

WHEREAS, it is the intention of this body to ensure access to loans that are low cost rather than low rate, since consumers buy goods with dollars and cents and not with annual percentage rates;

WHEREAS, NBCSL passed Resolution BFI-13-14, "PROMOTING SAFE AND AFFORDABLE LENDING PRACTICES," among the 2013 Ratified Resolutions and that resolution promotes adequate safeguards to protect the general community from abusive financial services;

WHEREAS, this resolution maintains that responsibly structured credit is an essential part of the wealth-building ecosystem, that includes building a sound credit history, as well as saving and wise investment;

# BUSINESS AND ECONOMIC DEVELOPMENT
## Resolution BED-16-21

WHEREAS, all small-dollar closed end credit should be "fully amortized," meaning that the Total of Payments defined under the Federal Truth in Lending Act, is repaid in substantially equal multiple installments at fixed intervals to fulfill the consumer's obligation;

WHEREAS, small-dollar closed end credit, when used prudently by consumers, may help establish, re-establish or improve credit scores;

WHEREAS, all small-dollar closed end credit should be reported to at least one of the three major credit agencies: Equifax, Experian and TransUnion;

WHEREAS, all small-dollar closed end credit should provide that the Total of Payments as defined in the Truth in Lending Act be repaid over at least a 120 day period in substantially equal payments; and

WHEREAS, Traditional Installment Loan Lenders offering amortizing small-dollar closed end credit, may prevent cycle of debt issues inherent with non-amortizing balloon payment loans.

THEREFORE, BE IT RESOLVED, that the NBCSL supports small-dollar closed end credit in the form of traditional installment loans;

BE IT FURTHER RESOLVED, that Traditional Installment Loan Lenders should be reasonably protected;

BE IT FURTHER RESOLVED, that the NBCSL supports the expansion of Traditional Installment Loans as an affordable means for borrowers to establish and secure small dollar closed end credit while preventing cycle of debt issues inherent with non-amortizing balloon payment loans; and

BE IT FINALLY RESOLVED, that a copy of this resolution be transmitted to the President of the United States, Vice President of the United States, members of the United States House of Representatives and the United States Senate, and other federal and state government officials as appropriate.

**SPONSOR: Representative Karla May (MO)**

**Committee of Jurisdiction: Business and Economic Development Policy Committee**

**Certified by Committee Co-Chairs: Senator Jeffery Hayden (MN) and Representative Angela Williams (CO)**

**Ratified in Plenary Session: Ratification Date is December 4, 2015**

**Ratification is certified by: Senator Catherine Pugh (MD), President**

# APPENDIX II

COMPASS PRINCIPLES

# The Compass Guide to Small-Dollar Credit

CFSI Center for Financial Services Innovation

www.cfsinnovation.com

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# 1. ACKNOWLEDGEMENTS

This Guide was developed by CFSI, with the support of the Ford Foundation and the Omidyar Network, and in consultation with a wide range of advisors from industry, consumer advocacy organizations, nonprofits and academia. These include:

Appleseed
Aspen Institute
BillFloat
Brundage Management Company
Capital One
Center for Responsible Lending
Clarifi
Community Development Finance
Consumer Federation of America
Consumers Union
Core Innovation Capital
Corporation for Enterprise Development (CFED)
Credit Builders Alliance
Enova
Float Money
Ford Foundation
Guaranty Bank
KeyBank
Kinecta Federal Credit Union
L2C, Inc.
LendUp
LexisNexis Risk Solutions
MasterCard
MetaBank/Meta Payment Systems
MetLife Foundation
Mission Asset Fund
National Consumer Law Center
National Council of La Raza
National Federation of Community Development Credit Unions
National Urban League
Neighborhood Housing Services of Greater Cleveland
NetSpend
New America Foundation, Asset Building Program
North Carolina State Employees' Federal Credit Union
Omidyar Network
One PacificCoast Bank
One PacificCoast Foundation
Progreso Financiero
Regions Bank
San Francisco Office of Financial Empowerment
Self-Help Federal Credit Union
Sunrise Banks
Texas Appleseed
The Leadership Conference on Civil and Human Rights
The Pew Charitable Trusts
Think Finance
UNC Center for Community Capital
Urban Institute
Visa
ZestFinance

We are grateful for the wisdom and guidance of our advisors in this process. However, the Guide does not necessarily reflect the individual views of these advisors. CFSI takes full responsibility for the end product, and all comments, questions or suggestions should be directed to CFSI.

# 2. OVERVIEW

## *Why a Guide on Small-Dollar Credit?*

Access to high-quality small-dollar credit is a key component of a successful financial life for many Americans. Millions of people use small-dollar credit products every year; in 2012, consumers spent an estimated $41.2 billion on such products (see Box 1). Having the ability to borrow relatively small sums, on reasonable terms, can help individuals weather a financial shock, smooth income fluctuations, build a positive credit history, and facilitate a wealth-building purchase. However, millions of Americans do not have access to small-dollar credit or only have access to high-cost, low-quality small-dollar credit products that too often lead them into a cycle of repeat usage and mounting debt.

The Center for Financial Services Innovation (CFSI) believes the opportunity and need are great to improve the marketplace for small-dollar credit. Well-designed products have the potential to help people turn a momentary credit need into an opportunity to improve their financial well-being. Voluntary standards for quality in the small-dollar credit marketplace can facilitate innovation by providing a roadmap for lenders who seek to meet consumers' credit needs in a responsible and sustainable way. With the support of the Ford Foundation and the Omidyar Network, CFSI convened a network of expert advisors to develop this set of specific guidelines and best practices for high-quality small-dollar credit as part of our Compass Principles program.

**BOX 1** *There is no one universally-accepted definition of what constitutes "small-dollar credit." Broadly speaking, the term typically refers to consumer loans of less than $5,000 with terms ranging from as little as two weeks to as long as three years.*

*According to CFSI's 2012 Financially Underserved Market Size Study, consumers spent an estimated $41.2 billion on small-dollar credit products in 2012; these include deposit advance, refund anticipation checks, pawn loans, payday loans, overdraft protection, secured and subprime credit cards, auto title loans, installment loans and rent-to-own. The study also includes revenue estimates for subprime and Buy Here Pay Here auto loans, but as these tend to be larger loans with longer terms, they are not considered "small-dollar credit" for the purposes of this Guide.*

*The practices in the Guide are generalizable to all types of small-dollar credit, except where it is indicated that the practice refers specifically to closed-end loans or lines of credit. The Guide does not suggest guidelines for overdraft protection, as it is sufficiently different from other types of short-term credit that it falls out of the scope of this Guide. The guidelines do, however, apply to overdraft lines of credit.*

2012 Financially Underserved Market Size Study. Center for Financial Services Innovation, December 2013.

## *Background on the Compass Principles*

The Compass Principles are aspirational guidelines to assure quality innovation and execution in financial services – services that enable people to transact, borrow, save and plan in ways that are beneficial to the consumer and profitable for industry. The Principles reflect the belief that the U.S. financial services marketplace can actively contribute to improving people's lives, and deliver sustainable value to all consumers and providers.

The four Compass Principles are:

- ***Embrace Inclusion: Responsibly expand access.*** Consumers, including those from traditionally underserved groups or communities, are creatively reached and well-served with a relevant suite of quality, affordable financial services that promote consumer choice and are provided in a safe, dignified and convenient manner.

- ***Build Trust: Develop mutually beneficial products that deliver clear and consistent value.*** Consumers can clearly understand and derive value, without pitfalls or unwelcome surprises, from financial products designed to align provider and consumer goals.
- ***Promote Success: Drive positive consumer behavior through smart design and communication.*** Consumers are empowered to make wise money choices via smart product design and guidance that is relevant to their specific concerns and financial situations, coincides in a timely fashion with key life events or decisions, and is immediately actionable.
- ***Create Opportunity: Provide options for upward mobility.*** Consumers have appropriate options that create opportunities for increased financial prosperity, and they are encouraged to pursue those opportunities.

The Compass Principles are guided by the following six values:

- ***Profitability and Scalability:*** The Compass Principles provide a framework that is pragmatic, achievable, financially sustainable and scalable.
- ***Deep Customer Knowledge:*** The Compass Principles are formulated and must be implemented with a solid understanding of real consumer needs.
- ***Safety:*** The Compass Principles support and build upon consumer protections.
- ***Variation and Choice:*** The Compass Principles allow for judgment on the part of individual providers, because there is no one right way to meet all customer needs.
- ***Relationships:*** The Compass Principles focus on success for both consumers and providers and encourage viewing each customer interaction as an opportunity for a long-term relationship.
- ***Cross-Sector Participation:*** The Compass Principles incorporate the perspectives of a range of practitioners and experts.

For additional information on the Compass Principles, please visit www.compassprinciples.com.

## *Scope of the Guide*

This Guide seeks to define characteristics of a high- quality small-dollar credit product. **It does not assume, however, that credit is the answer for every consumer.** For most people, the ability to borrow is an essential tool – along with the ability to transact, to save and to plan – for successfully managing their financial lives. Access to credit can help weather a financial shock, smooth income fluctuations, build a positive credit history, and facilitate a wealth-building purchase – all of which are keys to overall financial health.

For some people, however, access to credit might only worsen their financial situation. When people who face a chronic income shortfall or who already have debts they cannot manage use credit to meet their basic needs, they put themselves at risk of falling into a dangerous cycle of debt. Absent some significant change in their short-term financial situation, they will likely need to borrow again to repay the loan while still meeting their basic needs and other financial obligations in the next period. Mounting fees and interest can quickly spiral out of control, creating a new financial strain on the individual who is already struggling.

This Guide emphasizes responsible underwriting as a key component of a high-quality small-dollar credit product. As lenders' underwriting capability improves, due in part to the increased availability and utility of new data sources, some consumers who are currently accessing credit may no longer qualify.

It is difficult to estimate with certainty how many consumers might no longer qualify with more responsible underwriting. Research shows that some current small-dollar credit borrowers have expenses that regularly exceed their income; these are likely many of the same borrowers who find themselves in a destructive cycle of debt when they cannot repay their loans.[1] For these individuals, non-credit solutions such as job training, income support programs, budgeting help or savings tools might be more

1 CFSI's research suggests that approximately 30% of small-dollar credit borrowers have expenses that regularly exceed their income, according to their self-reported reasons for seeking credit. Regression analyses also found that borrowers who report this reason for seeking credit are more likely than other borrowers to rollover or extend their payday, pawn, auto title or deposit advance loan. "A Complex Portrait: An Examination of Small-Dollar Credit Consumers." Center for Financial Services Innovation, August 2012.

appropriate. Adequate consumer protections are also needed to shield vulnerable individuals against lending practices that are harmful or deceptive. While finding ways to support and protect the most vulnerable consumers is critically important, it is outside of the scope of this Guide.

## *Definition of Quality*

This Guide defines a high-quality small-dollar loan as one that:

1. Is made with a high confidence in the borrower's ability to repay
2. Is structured to support repayment
3. Is priced to align profitability for the provider with success for the borrower (see Box 2)
4. Creates opportunities for upward mobility and greater financial health
5. Has transparent marketing, communications, and disclosures
6. Is accessible and convenient
7. Provides support and rights for borrowers

**BOX 2** *At the heart of the Compass Principles is a commitment to mutual success in the customer-provider relationship. By reframing each customer interaction as a source of many future engagements, and aligning company culture and incentives accordingly, providers can successfully and profitably offer, structure, and sell products and services that promote a positive customer relationship. In the case of small-dollar credit products, it means designing business models and products such that the lender's profitability depends on borrowers' success with the product (i.e. high rates of on-time repayment, low default rates, etc.) without re-borrowing and while still meeting basic needs and other financial obligations; a high default rate should never be accepted as just another cost of doing business. It also means that employees should be incentivized based on success of the loan portfolio, not on the number of loans booked, and that borrowers should never be encouraged to refinance their loans as a way for the lender to generate additional revenue. Providers are encouraged to identify and track progress against specific consumer-focused Key Performance Indicators (KPIs) along with traditional financial metrics.*

While some of these characteristics are straightforward, others imply clear trade-offs. For example, assessing ability to repay requires that the lender gather and verify information about the borrower, including but not limited to his or her identity, income, credit history and other obligations, which may slow down the loan approval process, making the loan less convenient for some borrowers. Fortunately, consumers report a variety of needs for small-dollar credit, and therefore a one-size-fits-all solution is not the goal (see Box 3).

Much of the debate about small-dollar credit has heretofore focused on price, as expressed in Annual Percentage Rates (APR), as a primary determinant of quality. While affordable prices are certainly one aspect of high-quality small-dollar loans, what is "affordable" to any given borrower depends on many factors, including the loan's size, repayment period, interest rate and fees, as well as the individual borrower's unique financial

**BOX 3** *CFSI's research identifies four primary need cases in the small-dollar credit market: Unexpected Expense borrowers, Misaligned Cash Flow borrowers, Planned Purchase borrowers and Exceeding Income borrowers. The distinct profiles of the first three need cases suggests that different types of products (e.g. lines of credit versus installment loans, or loans of various sizes or with different distribution mechanisms) might meet those borrowers' needs. However, for Exceeding Income borrowers, access to credit might only worsen their financial situations.*

*Because this Guide emphasizes making loans with a high confidence in the borrower's ability to repay, lenders have a responsibility to use the best tools available to determine whether an applicant falls into this category, and if they do, not to extend credit to them. These consumers should be the target of interventions by policy-makers, governments and nonprofits designed to protect them from harmful or deceptive lending practices and to improve their financial situations. There may also be opportunities for financial institutions to devise other non-credit products, such as small-dollar savings, that can meet the needs of these consumers.*

"Know Your Borrower: The Four Need Cases of Small-Dollar Credit Consumers." Center for Financial Services Innovation, December 2013.

situation. *CFSI defines an affordable small-dollar loan as one for which the loan amount, repayment period, interest rate and fees are such that the borrower can successfully repay the loan without re-borrowing and while still meeting basic needs and other financial obligations* (see Box 4). In other words, whether a loan is affordable or not depends on underwriting, structure and pricing – not on price alone.

*Whether a loan is affordable or not depends on underwriting, structure and pricing -- not on price alone.*

*Underwriting.* As discussed earlier, loans should be made with a high expectation that the borrower will repay them, on-time and without renewing the loan. This means that lenders must invest in their underwriting capabilities, rather than accepting a high default rate as a necessary cost of doing business or relying on high fees from borrowers who are in a cycle of debt. As lenders' underwriting capabilities improve, they ought to be able to distinguish higher-risk borrowers from lower-risk borrowers, and price their loans accordingly. Credit should become much more affordable for the many consumers who use it responsibly.

*Structure.* Structure is just as important as price in determining whether a small-dollar loan is affordable. For example, for borrowers who struggle financially, a two-week loan with a balloon payment structure is often very difficult to repay, even at very low prices. In most cases, loans should be structured in fully-amortizing installment payments; the amount of the loan and the repayment period are variables that should be adjusted to ensure that the borrower can afford to make the regular payments while still having enough left over to meet basic needs and other financial obligations.[2] Borrowers should have the option to repay the loan early without penalty, preserving needed flexibility for those who wish to get out of debt more quickly. (However, lenders should not encourage borrowers to pay off early simply by refinancing or taking out another loan, a practice called loan flipping.)

*Pricing.* Lenders must be able make a profit in order to offer consumers lasting, high-quality solutions at scale. However, small-dollar credit products should not benefit the lender at the borrower's expense; in other words, the business model should rely on successful repayment, not high probabilities of default. Pricing should be designed to incentivize and reward positive behavior, lowering costs for consumers as they demonstrate creditworthiness over time. Lenders should not rely on punitive rates and fees as profit centers, and borrowers should not be penalized for good behavior. Over time, lenders should leverage improved underwriting capabilities and operational efficiencies to lower prices and extend credit to more qualified borrowers.

CFSI's vision for the future of the small-dollar credit marketplace is that consumers will have a variety of high-quality options that meet their small-dollar credit needs and support them on a path to long-term financial health. For this vision to become reality, lenders will need to develop and pilot new models for delivering small-dollar credit that meet the standards outlined in this Guide. As they do so, CFSI believes that competition for the small-dollar customer will increase, leading to lower prices, more diverse product structures, more innovative features and better customer service – all of which mean more and better choices for consumers.

**BOX 4** *Throughout the Guide, we say that an affordable loan is one that the borrower can repay without re-borrowing and while still meeting basic needs and other financial obligations. By "basic needs and other financial obligations," we are referring to necessities such as food, shelter and medical care, as well as debt service for other loans, including mortgage, student, credit card and other small-dollar loans. By "without re-borrowing," we are making a distinction between borrowing again at some future date because a new credit need arises (which does not necessarily indicate that the original loan was unaffordable) and re-borrowing immediately or shortly after repaying the original loan (which strongly suggests the borrower could not afford to pay back the loan while still meeting basic needs and other financial obligations in the next period).*

2 *We stop short of saying that loans should be made in installments in all cases. A loan with a balloon payment might still be considered high-quality if the loan is small enough that repayment in one lump sum remains affordable to the borrower.*

# 3. HOW TO USE THE GUIDE

## *Purpose and Audience*

The Compass Guide to Small-Dollar Credit is a tool for improving the quality of small-dollar loans through guidelines for their design and delivery. Lenders can use it to review or improve existing offerings, or to design new ones. Other actors in the small-dollar credit marketplace, such as investors, technology providers, consumer advocates or government agencies, can use the Guide to inform their own assessment tools for small-dollar loans.

## *Structure of the Guide*

The following sections outline each of the seven guidelines with a corresponding list of recommended practices. The practices are divided into three categories:

> **Core Practices**: These are the standards for a high-quality small-dollar credit product. A loan should not be considered high-quality unless it meets these practices.
>
> **Stretch Practices**: These are additional best practice ideas for providers looking to stretch beyond the basic requirements.
>
> **Next Generation Practices**: These practices are for providers that have met the standards for quality, challenged themselves to stretch beyond the basics, and are considering the next step in high-quality product design. These practices are called "next generation" to emphasize the need for new models for delivering small-dollar credit that may not yet exist today. We need additional customer-focused innovation, research and testing for these new models to emerge.

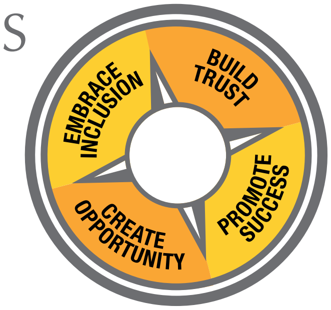
**Please note that the examples are simply for illustrative purposes and should not be used as a checklist.** Many of the practices in this Guide entail distinct business strategy decisions that are at the provider's discretion, and there is no one-size-fits-all approach to a high-quality small-dollar credit product.

## *How Not to Use the Guide*

This Guide is intended as a tool to help lenders design high-quality small-dollar credit products. **It cannot function as a "seal of approval" for any product or company, as CFSI does not monitor how individual lenders use this Guide or evaluate the extent to which they adhere to its principles.**

This Guide is not intended to provide advice about regulatory compliance. Users should seek legal counsel to ensure compliance with all applicable laws and regulations.

# 4. COMPASS GUIDELINES AND PRACTICES FOR SMALL-DOLLAR CREDIT




Alongside each guideline, the Compass Principle(s) most fully embodied by the guideline are identified. For each of the Core, Stretch and Next Generation practices, examples are provided to illustrate how a company might apply the practice.

This Guide defines a high-quality small-dollar loan as one that:

## 1 Is made with a high confidence in the borrower's ability to repay.

✓ EMBRACE INCLUSION
✓ BUILD TRUST
✓ PROMOTE SUCCESS

## CORE PRACTICES

**Use 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.**

*Examples:*

- Consider the borrower's overall relationship and history with the financial institution.
- Collect and analyze information about the borrower's other outstanding debt.
- Collect and analyze information about the borrower's total monthly income and expenses.
- Safely incorporate data not captured by traditional credit reporting.
- Analyze the borrower's deposit account inflows and outflows, either through the lender's own institution or through a third-party API.
- Develop a secondary scorecard that enables the institution to consider borrowers without a traditional credit profile.

**Do not make loans that rely solely on collateral for repayment.**

*Example:*

- If collateral is accepted (e.g. preauthorized ACH or payroll deduction), use additional underwriting techniques to ensure the borrower's ability to repay.

**Offer an appropriate loan product and amount based on each individual borrower's financial situation and the lender's risk.**

*Examples:*

- Offer "starter" loans in smaller amounts to borrowers for whom there is less available information (e.g. no traditional credit scores) and therefore for whom the risk to the lender is greater.
- Balance the amount borrowed and loan term to ensure that individual payments are affordable while minimizing the total cost of the loan to the borrower.
- Consider offering loan products (e.g. secured credit cards) that minimize risk to the lender while expanding access to borrowers seeking to build or re-build their credit.

**Monitor portfolio performance to ensure that most borrowers are using the product as designed, without defaulting or re-borrowing.**

*Example:*

- Set target rates for indicators of borrower success, such as the frequency of defaults, late payments or repeated use, and proactively adjust underwriting standards when these indicators suggest that borrowers are not succeeding with the product as designed. Tolerate only low rates for such indicators, even if high rates would not impair profitability.

# 2 Is structured to support repayment.

✓ BUILD TRUST
✓ PROMOTE SUCCESS

## CORE PRACTICES

**Design repayment timing and other product features to support and encourage successful on-time repayment.**
*Examples:*

- For closed-end loans, include repayment of principal with each payment (fully amortizing) and no prepayment penalty.
- For lines of credit, set default minimum payments to include both principal and interest, and encourage borrowers to pay more than their minimum payment each month.
- Balance the amount borrowed and the length of repayment to ensure that individual payments are affordable while minimizing the total cost of the loan to the borrower.
- Allow reasonable grace periods, enabling borrowers to avoid late payment fees and penalty interest rates.
- Enable borrowers to opt out of or reschedule automatic repayments within a reasonable grace period.

**Create meaningful safeguards to prevent harmful misuse or overuse of the product.**
*Examples:*

- For closed-end loans:
  - If a borrower takes out more than one loan at a time, ensure that total payments on all loans do not exceed the borrower's ability to repay.
  - Do not encourage borrowers to pay off their loans early simply by refinancing or taking out another loan.
  - Consider limits on the number of loans in a given period as means to prevent harmful misuse or overuse of the product.
- For lines of credit:
  - Periodically monitor and reevaluate the borrower's creditworthiness, reducing or increasing credit lines as needed to respond to changes in the borrower's financial situation.
  - Consider requiring that borrowers periodically reduce their balance to zero to prevent harmful misuse or overuse of the product.
  - Do not allow borrowers to exceed their credit limit.

**Provide support to borrowers when they have trouble repaying.**
*Examples:*

- Accept partial payments when a borrower has trouble repaying.
- Design flexible repayment plans for responsible borrowers facing difficult financial circumstances.
- Allow borrowers to put payments temporarily on hold when facing difficult financial circumstances.

## STRETCH PRACTICES

**Allow flexibility in setting repayment schedules that match income schedules.**

*Examples:*

- Set loan payment due dates to correspond with the borrower's pay schedule or receipt of other income.
- Allow borrowers to choose their own loan payment due dates and/or to reschedule them (within a reasonable grace period) at any time.

**Allow borrowers to customize the amount borrowed, loan term and payment amount up front in order to design a loan that fits their budgets, within ranges that underwriting suggests the borrowers can afford.**

*Example:*

- Provide an interactive online tool that shows prospective borrowers how much they will have to pay (both in individual payments and over the life of the loan) for various possible loan amounts and durations. Set defaults that encourage borrowers to pay off the loan as quickly as they can afford to do, to help them get out of debt faster.

## NEXT GENERATION PRACTICES

**Provide customizable alerts and tools that help borrowers manage their debt responsibilities effectively.**

*Examples:*

- Allow borrowers to choose to receive alerts before automatic payments are withdrawn, providing the option to approve the payment or reschedule it (with a reasonable grace period).
- Allow borrowers to choose to receive alerts when their loan balance reaches certain thresholds (e.g. when they have paid off X% of their loan, or they have $X left to pay before their loan is fully paid off), or when they have paid a certain amount in total fees.
- Offer online or mobile budgeting and personal financial management tools and/or access to third-party providers for those purposes.

## 3 Is priced to align profitability for the provider with success for the borrower.

✓ BUILD TRUST
✓ PROMOTE SUCCESS

## CORE PRACTICES

**Price loans to incentivize and reward positive behavior, lowering costs and/or increasing benefits for borrowers as they demonstrate creditworthiness over time.**

*Examples:*

- Incentivize automatic loan repayments from transactional accounts, while allowing the borrower the option to opt out at any time.
- Reduce rates over time for borrowers who demonstrate consistent repayment.
- Refund fees on a pro-rata basis when loans are paid back early.

**Do not rely on penalty fees and interest rates or fees earned from refinancing as profit drivers.**

*Examples:*

- Minimize late payment fees and penalty interest rates.
- Allow reasonable grace periods, enabling consumers to avoid late payment fees and penalty interest rates.
- Minimize upfront fees and use accounting methods that accrue interest over the life of the loan, to reduce loan officers' incentives to encourage borrowers to refinance.
- Actively help borrowers avoid penalty fees and interest rates through smart communication (e.g. alerts, targeted advice from customer service representatives, etc).
- Place a cap on the total amount of interest and late fees a borrower can pay on the loan to prevent rapidly accumulating costs in the event the borrower has trouble making payments.

**Ensure borrowers receive the most appropriate and lowest-priced loan for which they qualify.**

*Examples:*

- Provide opportunities to graduate to lower-cost products.
- Provide opportunities to refinance other high-cost debt at more favorable rates.
- Proactively monitor borrowers' use of the product to identify opportunities to graduate them to lower-cost products.

## NEXT GENERATION PRACTICES

**Provide additional benefits to borrowers who demonstrate positive behavior.**

*Example:*

- Offer appropriate additional financial service products to regular borrowers in good standing, such as reloadable prepaid cards with savings and budgeting tools.

# 4 Creates opportunities for upward mobility and greater financial health.

✓ BUILD TRUST
✓ CREATE OPPORTUNITY

## CORE PRACTICES

**Help the borrower leverage successful repayment into better credit opportunities in the future.**

*Examples:*

- Report repayment to major credit bureaus to help borrowers establish or build credit scores.
- Provide a clear path of graduation based on successful repayment, such as from a secured credit card to an unsecured credit card, or from one product to another with better terms and lower prices.

**If a borrower does not qualify for a loan today, provide actionable and specific advice that can help him or her work towards qualifying in the future.**

*Examples:*

- Provide referrals to credit counseling services that can help the borrower learn how to improve his or her score in the future.
- Offer information about other services, such as government benefits, job training or social services, which can help the borrower improve his or her financial situation.

**Leverage teachable moments to provide guidance about how to use the product successfully.**

*Examples:*

- Use key moments such as loan application, approval and servicing as opportunities to provide proactive advice to the borrower about how to avoid fees and qualify for better credit opportunities in the future.
- Allow borrowers to avoid a late payment fee or receive an interest rate discount by completing online financial education modules.

## STRETCH PRACTICES

**Provide borrowers with information about their credit reports and credit score at key moments over the life of the loan so they can observe in real-time how repayment behavior affects their credit profiles.**

*Examples:*

- Provide access to a credit score for all applicants, regardless of decision.
- Provide borrowers with free access to credit report monitoring services.
- Incorporate clear, easy-to-understand information about the borrower's credit score into periodic statements and/or an online dashboard.

## NEXT GENERATION PRACTICES

**Combine small-dollar loans with savings opportunities and incentives, helping borrowers improve their ability to manage future emergencies or cash shortfalls.**

*Examples:*

- Continue to direct automatic payments into a savings account after the loan has been fully paid off.
- Require that the borrower open a savings account as a condition of the loan and make a nominal contribution to the account as an incentive for the borrower to begin using it.
- Credit the application fee into the borrower's savings account if he or she pays the loan on time.
- Direct a portion of the loan amount into savings, and do not charge interest on that portion of the loan.
- Provide a bonus that gets deposited into the borrower's savings account when the loan is fully repaid.
- Allow the borrower to refinance higher-cost debt, and direct a portion of the savings from the lower payments into a savings account.

# 5 Has transparent marketing, communications and disclosures.

✓ BUILD TRUST
✓ PROMOTE SUCCESS

## CORE PRACTICES

**Disclose the full cost of the loan to the borrower in simple, clear and easy-to-understand language, with no hidden fees, industry jargon, misleading information or fine print.**

*Examples:*

- Prominently disclose, with equal weighting, the periodic and total cost of the loan, both in dollar terms and as an Annual Percentage Rate (APR) inclusive of all fees.
- Ensure that all disclosures comply with the requirements of the Truth in Lending Act's Regulation Z.
- Design the format and visual design of the price disclosure to be useful and easily understandable.
- Offer add-on products separately, once the loan has been funded, and on an opt-in basis only, with no hidden fees, industry jargon, misleading information or fine print.
- Provide prospective borrowers with information about the likely terms of their offer prior to submitting an application, especially if credit scores will be pulled as part of the underwriting.

**Provide borrowers with information about the loan product in a manner and language they can understand so that they can make better and more informed decisions.**

*Examples:*

- For closed-end loans, provide borrowers with a full payment schedule that shows the dates and amounts of all payments, including the amounts applied to interest and principal until the loan balance reaches zero.
- Use affirmative statements to enable borrowers to affirm that they understand the full cost of the loan and the consequences of late or non-payment, e.g. "I recognize that I will pay $X, and will pay $X extra if I do not do Y…"
- Provide periodic loan statements that clearly demonstrate success towards paying off the loan (and, if applicable, progress towards savings goals).
- Provide marketing collateral, loan applications, disclosures, statements and account information in multiple languages.
- Communicate decline decisions in a manner that is easy to understand and in compliance with the Fair Credit Reporting Act.
- Clearly communicate to prospective borrowers that their repayment behavior will be reported to major credit bureaus.
- Clearly market information about the risks to borrowers before they apply for the loan (e.g. that their credit reports will be pulled and employment verified, that they will be liable for making payments, the consequences of non-payment, etc.)

## STRETCH PRACTICES

**Clearly illustrate to borrowers in real time how much the loan will cost and how long it will take to pay off given actual or anticipated payment behavior.**

*Example:*

- Include a section in periodic statements and/or online dashboards that shows borrowers how much more quickly they will be able to pay off the loan if they increase payments by a given amount over their actual repayment behavior.

# 6 Is accessible and convenient.

✓ EMBRACE INCLUSION
✓ BUILD TRUST

## CORE PRACTICES

**Make loan decisions in a timely fashion, balancing the borrower's desire for quick access to funds with the lender's commitment to responsible underwriting.**

*Examples:*

- Leverage existing third-party platforms to enable borrowers to verify more of their information on the spot.
- Set clear expectations up front for prospective borrowers about how quickly they will receive a loan decision.
- Develop underwriting techniques that allow for prequalification for loans up to a certain limit, based on a preexisting relationship with the borrower.

**Ensure that loan application, decision, disbursement and servicing processes are convenient and culturally relevant.**

*Examples:*

- Allow applications to be accessed and submitted through multiple channels, such as in-person, by mail, by phone, online, via kiosk or via mobile device.
- Allow payments to be made through multiple channels, such as ACH, in-person, by phone, online, via kiosk or via mobile device.
- Provide the option of receiving funds distributions through multiple channels such as by paper check, direct deposit, wire transfer or payment directly to a third-party provider.
- Provide a loan dashboard online, via mobile platforms and/or through Interactive Voice Response (IVR) systems so that borrowers can easily access account information and make payments.
- Provide marketing collateral, loan applications, disclosures, statements and account information in multiple languages.
- Allow customers to use multiple forms of identification when applying for a loan (e.g. foreign identification).
- Allow customers to request mailed paper statements at a reasonable cost.

## STRETCH PRACTICES

**Use nontraditional delivery channels to increase access for the borrower, facilitate timely loan approval and minimize risk to the lender.**

*Examples:*

- Allow borrowers to submit applications and make payments at retail locations where they frequently shop, such as supermarkets.
- Tie loan approval and disbursement to the payment of a particular vendor, such as utility companies or auto mechanics.
- Work with employers to facilitate access to loans as an employee benefit.

# 7 Provides support and rights for borrowers.

✓ BUILD TRUST

## CORE PRACTICES

**Ensure that borrowers can obtain customer support easily and are treated respectfully and helpfully.**

*Examples:*

- Provide customer support through multiple channels, such as in-person, by phone, online, via kiosk or via mobile phone.
- Provide customer support in multiple languages.
- Develop Interactive Voice Response (IVR) systems that are available in multiple languages, easy to navigate, and make clear how to access a live agent.
- Provide contact information for the relevant state or federal regulatory body in the event the borrower wishes to register a complaint or seek additional guidance.
- Assign borrowers to individual relationship managers who are primarily responsible for providing them with customer support.

**Design dispute resolution and collection practices that are reasonable and fair to the consumer.**

*Examples:*

- Ensure that collection practices comply with the Fair Debt Collection Practices Act and all applicable regulations.
- Before initiating collections, reach out to the borrower and consider designing a repayment plan, waiving late fees or back interest, or other measures to assist with repayment.
- Provide an independent ombudsman process to resolve disputes.
- Do not use collections tactics that employ harassment or intimidation under any circumstances.
- Provide a process for borrowers to easily dispute errors in their credit reports.
- Develop and disseminate a Borrower's Bill of Rights.

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