Incentivizing Responsible Small-Dollar Lending in Low-Income Communities

Megha Bansal

Originally from the suburbs of Washington DC, Megha Bansal completed a Master of Public Policy degree from Duke University in 2012, and received dual Bachelor of Arts degrees in 2009 from the University of Maryland in Economics and Psychology, as well as a minor in International Development and Conflict Management. Prior to graduate school, Megha worked as a Paralegal at the Federal Trade Commission’s Bureau of Consumer Protection, helping to prosecute telemarketing, financial, and advertising fraud. Her work experience at the Federal Trade Commission exposed her to the many issues that low-income individuals face, particularly in terms of access to the financial services sector. In graduate school, Megha focused her studies on social policy as it affects low-income communities, and spent a summer with the Brookings Institution Metropolitan Policy Program exploring anti-poverty policies and low-income tax credits. Megha’s policy interests intersect many social and economic issues, including poverty, health, justice, and disaster response. Currently, Megha is a Federal Strategy & Operations Consultant at Deloitte Consulting in Washington DC, working with federal government clients to address their most complex problems while improving performance, efficiency, and innovation in the public sector.

Abstract

Recent economic turbulence has contributed to an increased need for short-term small-dollar loans, particularly for low-income individuals. In a world with no payday loan programs, low-income, high-risk consumers might be unable to obtain loans and would have little to no access to short-term cash options. Thus, the need for a small-dollar lending program is apparent. However, the current structure of the payday lending market is rife with information asymmetries, leaving lenders uncertain about risk levels associated with different consumers, and borrowers unaware of the consequences associated with how short-term loans are designed. Furthermore, proper incentives do not currently exist in the system to correct these information asymmetries and market failures. Based on the
problems identified with the small-dollar lending industry, the concept of a borrower’s card would address problems in term limits, borrowing amounts, and repayment plans. It would also increase data collection on the borrowing patterns of consumers, and create the most incentive for lenders to extend loans to consumers seeking small-dollar loans, while providing incentive for consumers to improve their own repayment behavior.

**Background**

Recent economic turbulence has contributed to an increased need for short-term small-dollar loans, particularly for low-income individuals. In many states, the payday lending market operates to meet this demand (Plunkett and Hurtado 2011:31-32; Saunders et al. 2010:4). Typically, individuals write a post-dated personal check to a lender or authorize electronic access to their bank accounts for the amount of the desired loan, generally less than $500, plus a transaction fee, typically a $15-$20 fee for a two-week $100 loan (Bair 2005:6-7). The lender holds the check until an agreed-upon date, usually the next payday, at which point the borrowers have the option to repay the loan and fee or allow the lender to deposit the check (Bair 2005:4). If borrowers are unable to repay the loan in full, they either face potential insufficient funds or overdraft fees, roll over the loan for an additional fee, or take out additional loans to pay back the first loan (Logan and Weller 2009:2). Lenders charge a higher interest rate to compensate for the risk of non-repayment (Caskey 2002:15) and the post-dated check serves as a low-cost form of collateral for lenders (Elliehausen 2009:2).

**Consumers Needing Payday Loans Display Varying Levels of Credit Risk**

Payday loans are typically taken out for convenience, to cover an emergency, or to pay for consumption needs. Consumers perceive payday lenders as an optimal way to meet immediate cash flow needs (Logan and Weller 2009: 2; Caskey 2002: 2). Generally, low-income individuals who use these alternative financial products may “lack financial savings, have bad credit and/or high debt-to-income ratios, cite privacy concerns, have a lack of comfort with formal financial services, [and] lack a basic consumer finance education” (Birkenmaier and Tyuse 2005: 72). While borrowers do
have checking accounts, some do not have credit cards, have poor credit scores, or have exceeded their credit limits (Barr 2004:2).

Payday lenders generally do not stringently underwrite their loans to assess credit risk or worthiness even though payday loan borrowers typically have a higher risk profile than prime borrowers (Center for Financial Services Innovation 2005:1; Lawrence and Elliehausen 2008:300). The underwriting for a loan consists simply of assessing whether the individual has a source of income to repay the loan (Lawrence and Elliehausen 2008:300). The focus is thus on an ability to collect, versus a consumer’s past payment behavior or capability to pay (Herrmann and Tescher 2008:15; Lawrence and Elliehausen 2008: 300).

**Payday Lending Market Contains Information Asymmetries**

Minimal barriers to entry make the payday loan industry competitive in nature (Schneider and Koide 2010:19). However, scholars suggest that the payday loan sector is a “textbook case of market failure,” because information asymmetries between borrowers and lenders lead to problems of moral hazard and adverse selection (Campbell et al. 2011:3). Moral hazard is perpetuated by models of payday lending in which lenders fail to properly verify repayment capability prior to issuing a loan, and instead, permit consumers to take out loans that they may not be able to afford. Adverse selection exists because there is no clear way for lenders to discern high-risk consumers from moderate- or low-risk borrowers. Representative data about varying consumers’ use of payday loans is limited (Lawrence and Elliehausen 2008: 304). Instead, it appears that all consumers are pooled and offered similar terms without consideration of variation in borrowing behavior and ability to repay.

Furthermore, borrowers are often unaware of the terms of their loans. While lenders are required to disclose necessary information pertaining to loans under the Truth in Lending Act (TILA), consumers may not easily understand the financial language (Mann and Hawkins 2007:882). For example, some consumers do not have an accurate understanding of just how expensive payday loans are and either report unrealistically low annual percentage rates (APR) or are unaware of their APR (Caskey 2002:3; Lawrence and Elliehausen 2008:308). This lack of understanding may lead consumers to inaccurately compare their financial options (Mann and Hawkins 2007: 882). The calculation stipulated by TILA for examining
annual percentage rates also excludes loan fees and charges, which could lead some borrowers to underestimate the true cost of payday loans (Plunkett and Hurtado 2011:50). Additionally, consumers may lose trust or confidence in the market’s ability to function, which could lead them to abstain from the traditional financial market altogether (Campbell et al. 2011:3).

**Payday Loans Are Poorly Designed**

Many borrowers who take out payday loans are unable to repay within a single pay period and thus must accrue additional fees to roll over their loans (Herrmann and Tescher 2008:6). The Center for Responsible Lending estimated that in 2008, the typical consumer who took out a payday loan ultimately paid $800 for a $300 loan, due to the accrual of additional fees and interest (Logan and Weller 2009:3). The organization also estimated that, of approximately 19 million payday loan borrowers, 12 million were “trapped in a cycle of at least five payday loan transactions per year” (Logan and Weller 2009:3).

Lenders claim that when the interest rates and fees are stated in terms of an annual percentage rate, it distorts the purpose of the loan, which is intended to be short-term in nature (Caskey 2002:3). However, what starts off as short-term can turn into long-term because of rollover and chronic borrowing patterns (Caskey 2002:32). These rollover options may be helpful in the short-run; however, they are particularly risky over time, because they allow these high interest rates to compound and drive already financially vulnerable individuals further into debt (Birkenmaier and Tyuse 2005:73; Saunders et al. 2010:14). Additionally, consumers often borrow from multiple lenders and thus accrue varying levels of debt based on prior loan obligations (Stegman 2007:176-177). Some estimates suggest that borrowers take out eight to nine payday loans annually (Saunders et al. 2010:4). According to the Center for Responsible Lending, 76 percent of payday loans are made to consumers who need to pay off previous payday loans (Plunkett and Hurtado 2011:34).

**Data on Borrowing and Repayment History Is Not Readily Available**

Only a few states have standardized databases with information on the borrowing and repayment history of payday loan consumers, which could help “enforce restrictions on rollovers and aggregate borrowing” (Elliehausen 2009:7). The lack of a centralized system makes it difficult to keep track of where consumers are originating their loans, how often
they are borrowing, and their true ability to repay (Stegman 2007:177). In the mainstream financial sector, consumers are linked to purchases and spending patterns through their credit score. However, data on short-term loans is generally entered on a 30-day cycle into credit bureau systems, despite the typical two-week repayment period (Herrmann and Tescher 2008:15). This lag time may affect the accuracy of data being used to underwrite loans. Furthermore, while some payday lenders collect and share data among themselves, the data is not widely available, particularly because the lenders often operate as private entities (Flannery and Samolyk 2005:4).

Since payday lenders do not typically report borrower behavior to credit bureaus in a timely manner, if at all, those consumers that are able to repay cannot “experience the credit rating benefits associated with timely repayment” (Fair Community Credit 2011: 5; Herrmann and Tescher 2008:15). Without a proper link to their borrowing history, consumers that are unable to repay the benefit of good credit ratings may have less incentive to repay their loans on time, in full, or at all. In the long term, these strategies are detrimental to establishing financial security. Ultimately, this situation creates a “fringe financial class without the capacity to build credit” (Fair Community Credit 2011:5).

A More Responsible Small-Dollar Lending Program Is Needed

In a world with no payday loan programs, low-income, high-risk consumers might be unable to obtain loans and would have little to no access to short-term cash options. Thus, the need for a small-dollar lending program is apparent. However, the current structure of the payday lending market is rife with information asymmetries, leaving lenders uncertain about risk levels associated with different consumers, and borrowers unaware of the consequences associated with how short-term loans are designed. Furthermore, proper incentives do not currently exist in the system to correct these information asymmetries and market failures. Scholars agree that if equivalent programs are designed more “responsibly,” they can benefit the population of consumers that needs the loans and has the capacity to repay (Campbell 2011:101).

More responsible loan programs have a variety of characteristics that ensure access to credit without trapping borrowers in additional debt. Ideal loans would comply with state and federal consumer protection and fair
lending laws, be underwritten based upon a borrower’s ability to repay, be long enough to allow for affordable repayment, and come with additional assistance (e.g., financial counseling or mandatory savings components) to assist consumers (New Yorkers for Responsible Lending [NYRL] n.d.:1). Consumers should have options in pricing, borrowing, and repayment plans, dependent on their specific needs, socioeconomic status, and discipline (Herrmann and Tescher 2008:13-14). Any program developed as an alternative to a payday lender must consider borrower need and behavior, as well as what would happen if access to loans was eliminated (Campbell 2011: 0).

Criteria

A responsible payday loan alternative should seek to:

• Minimize risk associated with consumers’ ability to repay loans: This criterion aims to reduce risk associated with consumer behavior and/or ability to repay by either better assessing consumer riskiness or ensuring that consumer risk does not prohibit or limit the potential for loan repayment. Any alternative must minimize this risk in order to ensure that lenders continue to provide access to short-term small-dollar loans.

• Provide incentive for lenders to extend loans to consumers seeking small-dollar loans: In order to operate, lenders must be able to accrue a positive expected return. Since the demographic that tends to need small-dollar lending may be high-risk, incentives must be offered for lenders to extend a loan without using discriminatory criteria. A viable alternative will provide incentives by reducing the level of consumer risk, either by allowing lenders to better examine consumer risk, or by guaranteeing compensation in spite of the risk levels.

• Provide incentive for consumers to improve repayment behavior: Consumers are not necessarily linked to their borrowing and repayment histories and thus are provided with little incentive to improve their borrowing behavior. A viable alternative should provide a mechanism by which consumers choose to improve their own repayment behavior, in order to mitigate their levels of risk in the eyes of a lender.
• Maximize sustainability of program implementation: Program design should consider factors of sustainability, such as operational cost, simplicity of implementation, political pushback, or scalability.

The tension that exists with designing an alternative program is in balancing consumer need, firm incentives, and market failures resulting from information asymmetries, in order to meet the demand for these loans without incentivizing unscrupulous or predatory behavior.

Alternatives

The following alternatives provide plausible program designs for a responsible small-dollar lending program. Each alternative will be discussed in detail and weighted against the specific criteria identified above. Each criterion is weighted equally in the analysis.

1. Use a referral process to provide loans to approved low-income and/or high-risk consumers.

2. Design a borrower’s card system to collect information about consumers’ borrowing and repayment behaviors.

3. Fund a loan loss reserve pool to back loans made to low-income and/or high-risk consumers.

This analysis is based on the distinct design components, not the specific city or state programs discussed, and seeks to analyze the design components independent of one another in implementation.

Alternative 1: Referral Process to Provide Loans

This alternative is modeled after the Fair Community Credit program in Kansas City, which utilizes trained program referral partners to make loans to low-income individuals or subprime borrowers. The program also includes a loan loss reserve funded by foundations and individuals, a minimum income level, capped interest rates, limited borrowing amounts and term limits, and financial education. In its first year of operation, the program expected to make only 500 collateralized loans (Associated Press 2012).
The referral system incorporates and leverages borrowers’ social networks into the lending process (Schneider and Koide 2010:78). Community, peer-based international microfinance programs (Herrmann and Tescher 2008:12) have shown that loans made to individuals within an existing social network are more likely to be repaid, because individuals have been identified as responsible or trustworthy (Fair Community Credit 2011:11). The Kansas City group cites Grameen Bank’s 97 percent repayment rate, attributing this success to monitoring within social networks that exerts social pressure to repay and provides a safety net if borrowers experience financial distress (Fair Community Credit 2011:11). Fair Community Credit uses a referral system of trained community and neighborhood institutions. These institutions may be nonprofit organizations, congregations, or social service providers that are specifically targeted as referral partners. Training is provided by professional community organizers.

According to Fair Community Credit, “good” borrowers tend to exhibit four characteristics: they have an acute and specific financial need, maintain a pre-existing relationship with a referral partner, demonstrate a willingness to improve their financial situation, and meet the minimum criteria for underwriting. After receiving a letter of endorsement, information about the client’s loan is entered into an online tracking system to which only the referral partner, the partner bank representative, and Fair Community Credit have access. The online tracking system does not collect sensitive information like social security numbers or credit scores. Fair Community Credit uses the system to track referrals made by each partner to ensure that quality referrals are being made. After receiving a referral, all borrowers must also undergo an underwriting process with the partnering bank before qualifying to receive the loan.

Analysis of Alternative 1

The risk associated with repayment stems from uncertainty about the individual’s ability or propensity to repay the loan. A referral system provides some mitigation of risk compared to a walk-in customer for whom there is no basis for assessing ability to repay. The referral system uses trusted community partners that are able to speak to consumers’ character, morals, or other related characteristics beyond financial means that might affect their tendency to repay.
While a standardized referral procedure would minimize subjectivity concerns, it is uncertain whether referral systems provide enough incentive for lenders to extend loans to borrowers perceived as particularly risky. Referral and community partners may be biased in favor of borrowers drawn from their population of interest. Banks and lenders are more concerned with repayment, and without a guarantee of collateral or profitability, the referral may not be enough to incentivize them to extend loans. Furthermore, it is uncertain whether a referral system would provide a concrete incentive for consumers to improve repayment behavior, particularly if the referral is based on a pre-established relationship. Indirectly, borrowers may try to utilize their relationships with community partners more in order to gain favor prior to and during the referral process. Because the referral is more of an assessment of the consumer’s situation and need, it may not directly provide the incentive to improve behavior.

A referral system keeps the pool of borrowers relatively small, since community partners would have to base referrals on established relationships, extensive counseling, and referral meetings. Maintaining a smaller pool of approved borrowers helps with financial sustainability. Moreover, community partners could always be added to the program if the program expanded or if partners withdrew. Additionally, low default rates of repayment would help with sustainability, since over time, lenders might observe that the referred consumers were reliable and be more willing to develop a relationship with the referral program. However, more evaluation is needed to determine default history and repayment with the referral process.

**Alternative 2: Borrower’s Card to Collect Information**

Alternative 2 proposes a program similar to grocery store discounts. Cards would be used to track consumer purchases and spending histories. In the case of grocery store discount cards, the information a store gains about consumers is likely more valuable than the discounts enabled by the card.

Individuals who desire a small-dollar loan could opt into this voluntary card program through an existing credit union. Participants would receive
a personalized borrower’s card and be required to submit a fingerprint scan, to minimize the chances of borrowers obtaining multiple cards. To ensure access for low-income consumers in need, such as undocumented immigrants or those with nontraditional jobs, the card would not be linked to an individual’s social security number. Each time a consumer receives a small-dollar loan, details about the loan amount, borrowing date, interest rates, and repayment schedule could be collected electronically. The loan would not necessarily have to accrue to the borrower’s card, though there are program models (such as Progreso Financiero) that provide their loans through a pre-paid card (Baddour et al. 2011:48).

An incentive system could be worked into the program design, in which consumers would receive a rating similar to a credit score. This “shadow credit rating” would be calculated based on information from borrowers’ cards, including how quickly consumers repaid their loans, whether consumers received financial counseling, whether consumers participated in financial education or homeownership classes, and whether consumers opened savings accounts or maintained a minimum balance, among other factors. These behaviors would provide bonus points for the shadow credit score. Progreso Financiero developed its own credit assessment underwriting model to assess repayment ability that uses an in-depth online questionnaire and more than 1,300 attributes of nontraditional data, such as rental history, utility payments, and home or car ownership (Del Bosque 2011). Progreso Financiero developed this model because only three percent of its loan applicants have a sufficient credit history or high enough credit score (Baddour et al. 2011:47).

Lenders could offer incentives such as lower interest rates, longer repayment plans for those with positive payment histories, or higher loan amounts to encourage consumers to build shadow credit scores. Under the Progreso Financiero model, individuals who repay their loans on time are able to receive better terms on their next loan (Moran 2011). Progreso Financiero also reports borrowers’ payments to credit bureaus and found that almost 90 percent of their borrowers increased their credit score from their first loan (Saunders et al. 2010:23).

Some discussion of innovative small-dollar lending programs focuses on whether consumers can transition to the mainstream financial system after a certain amount of time (McKernan and Compton 2010:6). With the borrower’s card, if consumers reach a shadow credit score of a certain
threshold amount based on their behavior and loan repayment, they may reach interest rate levels with the small-dollar lending institution comparable to the prime interest rates obtainable at a bank. Slowly and with counseling, consumers may then be able to transition over to the “traditional” banking sector.

Piloting this program at an existing community financial institution or credit union may help to link shadow credit ratings to real credit scores. Furthermore, an existing credit union may experience lower operating costs due to preexisting infrastructure, staff, physical space, and processes (Bair 2005:28).

**Analysis of Alternative 2**

The borrower’s card increases data collection on a consumer’s loan history, borrowing behavior, and repayment ability, and makes it available to participating lenders (e.g., credit unions). This system fully meets the criterion of minimizing risk associated with a consumer’s ability to repay loans.

First, the card would hold consumers responsible for their lending and borrowing patterns by linking their behavior to their potential to obtain loans. The card provides an incentive for consumers who frequently borrow and repay their loans to engage in the program because of the potential to receive reduced interest rates, larger loan amounts, and varied payment plans. The data collection thus helps to separate very risky individuals, who likely would not qualify for a loan at all, from those that are less risky. This provides an incentive for high-risk consumers to improve their behavior. However, to the extent that these consumers do not improve behavior, it is possible that their financial outcomes will worsen because moderate- or low-risk individuals formerly pooled with them will no longer be subsidizing their loans.

Amassing any large database of information may pose privacy concerns, especially if a biometric was used to ensure that borrowers could only receive one card. However, there are ways to minimize privacy concerns. The data collected could exclude personally identifiable information, such as social security numbers and credit scores. The database should be nonpublic and only shared with participating lending institutions and credit unions that agree to the terms of the borrower’s card loan program. This provision would exclude any payday lending operation from access to the
database, since their loan terms and interest rates would not comply with program design. Furthermore, limiting access may actually encourage more credit unions to participate, in order to increase the amount of information they receive about potential borrowers.

In order for lenders to extend loans to an individual, there must be some assurance of profitability. When repayment is uncertain, lenders are less likely to extend a loan to an individual. The borrower’s card system would create a viewable database of information on a consumer’s borrowing and repayment history, providing lenders with incentive to extend loans for two reasons. First, lenders are able to use the consumers’ financial behavior to assess their ability and history of repayment. Second, consumers who borrow frequently and consistently repay are more likely to use the card because of the potential for a reduced interest rate. Thus, lenders have some indication that the borrower is able and willing to repay. This mechanism is somewhat comparable to the way in which the credit card industry has used market segmentation to offer varying terms and interest rates to consumers based on their respective financial characteristics. The information technology advances in the credit card industry may have some applicability to the small-dollar loan or payday lending industry as well (Mann and Hawkins 207:912).

Very high-risk consumers who frequently take out loans they are unable to repay may be shut out of the borrowing market, because the card system exposes their behavior and inability to repay. However, a responsible lending program need not ensure that every individual pursuing a loan receives one. The National Consumer Law Center states that “the criteria for responsible small loans must be considered on their own merits, without excessive concern for whether or not they will permit the wide availability of easy credit that gets payday borrowers in trouble today” (Saunders et al. 2010:8). Thus, it is critical that those who need loans and can repay them are not denied access because they are clustered with high-risk borrowers.

Alternative 2 creates an incentive for consumers to participate in this program, particularly those that frequently take out these loans or genuinely need these loans to supplement their income. By taking ownership of their borrowing behavior and building a history of good repayment, consumers are able to receive needed financial assistance at a potentially lower interest rate. Additionally, through their behavior, individuals can demonstrate their
ability to repay and subsequently, lower their perceived risk as a borrower. This feature helps address issues of adverse selection in the population.

A few states have created centralized databases for information regarding consumers’ payday loans, in order to prevent rollover or chronic borrowing (Elliehausen 2009:7). However, these databases simply collect information for lenders to use and do not seem to provide consumers any incentive to improve their own financial behavior. This is in contrast to the borrower’s card design, which would use the possibility of lower interest rates to incentivize higher repayment rates and better loan terms. However, this assumes that interest rates are a strong enough incentive mechanism. Other incentives might include longer repayment plans or higher loan limits. Furthermore, the potential for using good repayment behavior in the construction of a shadow credit score as the basis for transitioning to the traditional banking sector would provide individuals who are typically unable to access prime interest rates incentive to work toward that goal.

This alternative helps create a long-term relationship between consumers and their borrowing behavior, by pegging an individual’s borrowing history to future interest rates and loan terms. Individuals are linked to their borrowing behavior over time, creating a more sustainable lending model than systems that allow individuals to take out many loans from a variety of lenders. In the case of a state where it might be difficult to block political legislation that allows payday lending to take shape, this alternative might provide a way of tackling the issue from the other end, by reducing the need and demand for payday loan shops and encouraging more reliance on credit unions or other community lenders.

**Alternative 3: Loan Loss Reserve Pool to Back Loans**

In the small-dollar lending industry, borrowers tend to be risky and lenders are often hesitant to provide loans without some sort of collateral or guarantee of repayment. This alternative would create a loan loss reserve pool of funds in order to back the loans made to borrowers. Lenders could draw from the fund when borrowers are unable to repay their loans, in order to ensure that the lender is able to break even. The loan loss reserve fund would help lenders obtain more financial capital to help expand their business and increase the number of loans that could be made affordable (Schneider and Koide 2010:19).
Depending on the design, loan loss reserve pools could back the loans in entirety, or could partially back the loans up to a certain percentage, leaving the lender to potentially face some risk of loss. Loan loss reserve pools could also be funded in different ways. The Fair Community Credit program’s $200,000 loan loss reserve pool is funded by individual and community donations, and is held in a Certificate of Deposit at the partner bank. The fund earns interest and is used to back 100 percent of loans made to individuals who are referred to the partner bank. In contrast, the Pennsylvania Credit Union Better Choice program funded their loan loss reserve pool from monies earned above the market rate-of-return on a $20 million dollar investment from the Pennsylvania Department of Treasury into the credit union system (FDIC 2010:75). The loan loss reserve pool was then used to reimburse up to 50 percent of any lender losses (Schneider and Koide 2010:11).

**Analysis of Alternative 3**

Lenders want to ensure that whatever loans they extend will be repaid, typically so their businesses can break even or make a profit. In general, lenders are most concerned about protecting their businesses from loss, and the loan loss reserve pool provides that protection. Depending on the design of the loan loss reserve and the share of a loan a fund can guarantee, it either partially or fully meets the criterion of minimizing the risk of not being repaid. However, it is important to note that the loan loss reserve pool is specifically set up with the lender’s interests and profitability concerns in mind.

The loan loss reserve alternative partially meets the criterion of providing lenders incentives to extend small-dollar loans since they have a positive expected return. However, it is possible that lenders are provided with too much incentive to make loans to any individual, regardless of risk, simply to ensure a profit. With the assumption that all loans are backed, potentially risky consumers may be offered loans they cannot afford. A blanket guarantee against any loan losses makes riskier loans seem more attractive, contributing to the moral hazard consumers and lenders both experience. A partial reimbursement may provide the correct amount of incentive, while not overcompensating the risk pool.

This alternative does not meet the criterion of providing consumers with incentive to improve their own repayment behavior. The loan loss
reserve pool is used to back all loans made to consumers in the hope that lenders will find more incentive to extend loans. Consumers are aware that even if they are unable to repay, the lender will still receive a return on the loan. With a loan loss reserve pool, consumers are not necessarily held accountable for the loans they receive. Furthermore, the existence of the loan loss reserve suggests that as long as a loan is repaid, no matter by whom, the loan is appropriate to make. This situation reduces the obligation borrowers feel to repay. Even if penalties are imposed on consumers in order to induce them to repay, the loan loss pool itself is not incentivizing the improvement in their behavior. This could be a particular problem for more high-risk consumers, who may seek out these small-dollar loans more frequently since they know that lenders may be more willing to extend a loan to them.

A critical concern with sustaining a loan loss reserve pool is where funds will come from and how the pool can be replenished over time. Within the program design, there may be ways to include additional fees to help sustain the loan loss reserve. For example, every consumer that takes out a loan could pay a per-loan fee, a one-time fee, or an annual fee toward the pool. However, this tactic poses additional trade-offs with both access and overuse. If fees were assessed with each loan, high-frequency consumers would be required to pay more. But annual or one-time fees may actually encourage consumers to take out more loans, since they would incur no further cost. Finally, the concept of charging additional fees may be inconsistent with the idea of offering an alternative to payday lending, which hinges its own profitability model on additional fees to consumers. Thus, while there are ways to incorporate additional mechanisms to fund a loan loss reserve, they come with significant trade-offs.

**Recommendation**

Based on the problems identified with the small-dollar lending industry, Alternative 2 provides the most flexibility to create a responsible small-dollar lending program. The concept of a borrower’s card would address problems interim limits, borrowing amounts, and repayment plans. It would also increase data collection on the borrowing patterns of consumers and could provide further insight into creating other financial programs that could more appropriately target individuals based on their level of risk.
While Alternative 1 and Alternative 3 offer benefits that the borrower’s card perhaps does not, Alternative 2 best incentivizes responsible small-dollar lending by both encouraging lenders to extend loans to low-income individuals and encouraging consumers to take ownership of their own financial behavior.

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