



UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND
CONSUMER PROTECTION

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HEARING ENTITLED:
“ARE ALTERNATIVE FINANCIAL PRODUCTS SERVING CONSUMERS”

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WEDNESDAY, MARCH 26, 2014

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STATEMENT FOR THE RECORD

SUBMITTED BY
THE AMERICAN FINANCIAL SERVICES ASSOCIATION

Mr. Chairman,

The American Financial Services Association (AFSA) and its member companies commend you and you colleagues for holding this important hearing on the need that millions of Americans have to access small dollar consumer credit market. As the trade association representing traditional installment lenders, AFSA welcomes this opportunity to provide you with testimony about how the traditional installment industry meets the credit needs of millions of American families in a safe and affordable fashion.

AFSA is the national trade association for the consumer credit industry, protecting access to credit and consumer choice. Its more than 350 members include consumer and commercial finance companies, auto finance/leasing companies, mortgage lenders, mortgage servicers, credit card issuers, industrial banks and industry suppliers.

History of Small-Dollar Lending

To help understand the traditional installment lending industry, it is important to know its origins. Traditional installment lenders have been around for more than 100 years. They are community-based lenders located in cities and towns nationwide that provide consumers with small loans to buy goods and services.

In 1916, a group of lenders, along with charitable community organizations, promoted state laws that would make unsecured personal loans more readily available. The result of their efforts was the Uniform Small Loan Law, landmark legislation that the authors intended to be adopted by the states to provide an exception to usury laws so that consumers could legally obtain small amounts of credit at reasonable rates that allowed lenders to make a profit. As the new industry attracted capital, average wage-earners found that they could obtain loans from these personal finance companies for personal and family household purposes. As the companies expanded, they began to serve their customers through branch offices located in the neighborhoods where people lived or worked. The branch offices emphasized convenience and personal service.

Traditional Installment Loans

The same myriad qualities and attributes that initially drove the traditional installment loan industry have carried through to modern times. Traditional installment lenders continue to provide individualized service to the customers they serve in their communities.

Traditional installment loans are structured to help borrowers meet a financial need within their budget, repay the loan in substantially equal monthly payments and build a positive credit history. Traditional installment loans allow consumers to access small-dollar loans that represent financial freedom, flexibility and safety.

Traditional installment lenders work with borrowers to create a monthly budget based on their current income and expenses to determine if the borrower has the ability to repay the loan, and set the monthly payment at an affordable amount. Traditional installment loans are fully amortizing, meaning that part of each payment pays down the principal as well as the accumulated interest.

Traditional installment lenders report their customers' payment behavior to credit bureaus, which can help them build or strengthen a credit history over time. Traditional installment loans do not charge penalties for early repayment, or prepayment, and do not require large one-time balloon payments. Traditional installment loans are structured to provide borrowers with a plan for disciplined debt reduction.

Traditional installment loans provide customers with access to funds that:

- Can be repaid in affordable substantially equal monthly payments, or installments, reducing both principal and interest each month;
- Fit within the customer's monthly budget based on current income and expenses;
- Build a positive credit history, as traditional installment lenders generally report to credit bureaus;
- Do not allow for prepayment penalties or balloon payments.

Importantly, traditional installment loans are distinct from other types of small-dollar loans primarily because of their structure. Unlike other types of small-dollar lenders, traditional installment lenders underwrite their loans, meaning they consider a customer's ability and willingness to repay the loan. Likewise, the schedule of repayments for a traditional installment loan is no less than thirty (30) days. Additionally, the annual percentage rates (APR) on traditional installment loans are substantially lower than for payday, pawn or auto title loans. Structured in this time-tested fashion, traditional installment loans provide borrowers with a plan for disciplined debt reduction.

Consumers Served by Installment Lenders

In addition to hourly workers, traditional installment lenders serve the “unbanked” and “underbanked” – consumers who do not have or do not regularly use traditional banking services such as savings and checking accounts. Many of these consumers have poor or thin credit histories, making it hard for them to qualify for other forms of credit. Yet, traditional installment lenders have been making responsible and affordable loans to these very consumers for many decades.

Last year, the Center for Financial Services Innovation (CFSI) published a report¹ detailing four reasons that borrowers of small-dollar credit used these products, which CFSI defined as payday loans, pawn loans, deposit advance loans, auto title loans and non-bank installment loans. CFSI's research determined that consumers use small-dollar credit: 1) for unexpected expenses such as an automobile repair, 2) to cover misaligned cash flow, 3) to make up for exceeding income, or

¹ Bianchi, Nicholas and Rob Levy. *Know Your Borrower: The Four Need Cases of Small-Dollar Credit Consumers*. December 2013. Available at http://www.cfsinnovation.com/CFSI_KnowYourBorrower.pdf.

4) for planned purchases such as a new appliance. Of these “need cases,” installment lending was used most often for planned purchases (51%) and to pay for unexpected expenses (29%). Installment loans were rarely used by borrowers with misaligned cash flow.²

Consumers from all walks of life and all ends of the credit spectrum have varying credit needs, which the CFSI study reinforced. “Our findings provide further evidence that [small-dollar credit] consumers are not a homogeneous market that can be served with a one-size-fits-all approach.”³

Traditional installment lenders fully support and comply with the Equal Credit Opportunity Act (ECOA), which prohibits any kind of age discrimination. Specifically, the ECOA provides that: “It shall be unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction (1) on the basis of race, color, religion, national origin, sex or marital status, or age (provided the applicant has the capacity to contract); (2) because all or part of the applicant’s income derives from any public assistance program.”⁴

Endorsed by State Legislators

Both the National Black Caucus of State Legislators and the National Hispanic Caucus of State Legislators adopted resolutions in recent years acknowledging the need for small-dollar credit in which they emphasized that the “key structural qualities of loans that are safe and affordable are that the lender makes good faith efforts to assess the borrower’s ability to repay the loan and that the loan is repayable in substantially equal installments of principal and interest, with no balloon payments.”^{5 6} These resolutions describe traditional installment loans. They do *not* describe other forms of non-bank loans that increasingly characterize themselves as “installment loans.”

FDIC Pilot Showed Banks Can’t Compete in the Space

Small-dollar loans are not sustainable products for banks, as demonstrated by the Federal Deposit Insurance Corporation (FDIC)’s Small-Dollar Loan Pilot Program conducted in 2008 and 2009. The pilot, which recognized the obvious need for responsible and affordable small-dollar credit, concluded with 28 bank participants. The banks that participated in the pilot offered closed-end installment loans with APRs at 36 percent or less, including origination fees.

The FDIC touted the program as a success, although the majority of the banks in the pilot could not make a profit on small-dollar loans. The “success” of the program was based on using the products to build relationships and cross-sell other more profitable products to customers.

² *Ibid*, Table 1, p. 12

³ *Ibid*.

⁴ 15 U.S.C. Sec. 1691(a)

⁵ National Black Caucus of State Legislators. *Resolution BFI-13-14: Promoting Safe and Affordable Lending Practices*. Available at <http://www.nbcsl.org/public-policy/resolutions/item/624-business-financial-services-and-insurance-resolution-bfi-13-14.html> (December 2012).

⁶ National Hispanic Caucus of State Legislators. *Resolution 2013-10: Promoting Safe and Affordable Lending Practices*. Available at <http://www.nhcsl.org/94/resolution/promoting-safe-and-affordable-lending-practices> (November 2013).

“About three-quarters of pilot bankers indicated that they primarily used small-dollar loans to build or retain profitable, long-term relationships with consumers and also create goodwill in the community.”⁷

The pilot participants found that the costs of launching, marketing and offering small-dollar loans were similar to other loans. “As a general guideline, pilot bankers indicated that costs related to launching and marketing small-dollar loan programs and originating and servicing small-dollar loans are similar to other loans. However, given the small size of [these loans], the interest and fees generated are not always sufficient to achieve robust short-term profitability. Rather, most pilot bankers sought to generate long-term profitability through volume and by using small-dollar loans to cross-sell additional products.”⁸

“Banks other than those in the pilot provide small-dollar loans, but it is likely that most banks do *not* offer these loans. Pilot bankers and other banks that have started or have expressed interest in starting a small-dollar loan program indicated that the primary obstacles to entry are the cost of launching and maintaining the program and concerns about defaults.”⁹

The FDIC concluded that “the relationship-building small-dollar loan model is as costly to originate as other, larger loans because of the ‘high-touch’ nature of the loan delivery process.”¹⁰ The high-touch nature and the associated business costs with making small loans means that lenders must charge rates above 36 APR to make a profit.

Thus, while the FDIC touted the program as a success, a careful review of the findings shows that without significant changes to the banks’ lending programs, including a request for government guarantees, the majority of the banks in the pilot could not make a profit on small-dollar loans. Rather, the alleged “success” of the program was based in part on using the products to build relationships and cross-sell other more profitable products to customers. Moreover, to the extent the banks found that they might be able to make small-dollar loans, they based those conclusions upon establishing business practices that closely resembled the business practices of traditional installment lenders – AFSA’s members. Traditional installment lenders have already learned how to, and for many decades have, made responsible and affordable small-dollar loans to consumers who need access to small amounts of credit and who are not served by the traditional banking system.

APR

Every loan, regardless of type or size, has certain expenses built into the APR, as indicated in the FDIC Pilot Program. These costs are directly related to the work the lender puts into making each loan, such as underwriting, rent, salaries, licensing and regulatory compliance. These fixed costs and overhead expenses are the same for each loan, whether the loan is for \$1,000 or

⁷ *A Template for Success: The FDIC’s Small-Dollar Loan Pilot Program*. FDIC Quarterly 4, no. 3. 2010. Available at http://www.fdic.gov/bank/analytical/quarterly/2010_vol4_2/smalldollar.html.

⁸ *Ibid.*

⁹ *Ibid.*

¹⁰ *Ibid.*

\$20,000. So in general, bigger loans tend to have higher costs but lower APRs, while smaller loans will have lower costs and higher APRs. In many cases, APR will have an inverse relationship with a borrower's out-of-pocket costs.

APR tells a borrower the interest rate, but not the cost in actual dollars and cents to be paid over the life of the loan. Paying the same rate for a longer period of time makes the overall cost go up. Illinois Attorney General Lisa Madigan notes on her website that the least expensive alternative to payday loans is the small consumer loan, due in part to their longer repayment term. "In addition to having lower interest rates, small consumer loans have longer terms than payday loans – typically lasting about a year or more. Stretching your payments out over time is one way to help keep them manageable."¹¹

In a recent report, CFSI noted that "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 situation. ... In other words, whether a loan is affordable or not depends on underwriting, structure and pricing – not on price alone."¹²

In its March 2013 Semi-Annual Report, the Consumer Financial Protection Bureau (CFPB) recognized the difficulty in using APR to compare small-dollar loans and that consumers are most concerned about obtaining a loan quickly and conveniently. "While the cost of obtaining a loan may be a major consideration when deciding to take on debt and selecting which credit product to use, it is not the only factor in a consumer's decision-making process. For example, in some surveys, borrowers of small dollar amounts have overwhelmingly cited the speed, convenience and near-certainty that they will be approved for a loan as the primary considerations for using these products. ... Consumers on the subprime end of the credit scale potentially hav[e] fewer credit options."¹³

States highly regulate the terms and conditions (and often the maximum rates) for small-dollar loans. States seek to ensure availability of credit while recognizing that small transactions have high transaction costs. In states that have no cap, lenders study the market and price their products commensurate with the cost of capital, staff expenses, underwriting and anticipated losses.

With little statistical information about small installment loans available, AFSA began surveying its members about installment loans. Last year, the association published a report on "Preliminary Findings from the AFSA Member Survey of Installment Lending." The report

¹¹ Illinois Attorney General Lisa Madigan. *The Truth about Payday Loans*. At <http://www.illinoisattorneygeneral.gov/consumers/paydayloans.html>.

¹² *The Compass Guide to Small-Dollar Credit*. February 2014. Available at <http://www.cfsinnovation.com/content/compass-guide-small-dollar-credit>.

¹³ *CFPB Semi-Annual Report*. March 2013. p. 38. Available at http://files.consumerfinance.gov/f/201303_CFPB_SemiAnnualReport_March2013.pdf.

examined 2.4 million installment loans made between April and September 2012. The data show that “the highest APRs are associated with the smallest loans, which are also the loans with the shortest maturities.”¹⁴

The report compared loans in Pennsylvania, which has a 36 percent rate cap, with loans in Texas, which does not have a rate cap. Borrowers in both states have similar credit scores, with 84.9 percent of Pennsylvanians and 89.3 percent of Texans having credit scores under 660 – meaning that the majority of borrowers in both states would be considered subprime.

Because of the rate cap in Pennsylvania, 98.9 percent of small-dollar loans were for amounts greater than \$1,000. But in Texas, 71.7 percent of small-dollar loans were for amounts less than \$1,000. These numbers suggest that small loan sizes are generally unavailable in Pennsylvania and that borrowers in the state may be taking out larger loans than needed. This example “highlights difficulties that occur when rate ceilings prevent subprime borrowers from obtaining loans in the sizes they desire and have to obtain larger loans than necessary to be able to obtain loans at all.”¹⁵ As a result, borrowers in Pennsylvania have to repay more principal, which could pose a financial risk for them.

Additional borrowing for a longer period of time means consumers have higher finance charges – or higher overall costs – despite a lower APR. In Pennsylvania, most loans had APRs from 19 to 36 percent, while in Texas, most loans had APRs from 49 to 99 percent. Yet Pennsylvanians also had higher monthly payments than their Texas counterparts. In Pennsylvania, 56 percent of the loans had monthly payments greater than \$150, while in Texas, only 16 percent of the loans had monthly payments greater than \$150.

Comparing the loan amounts, terms, and monthly payment amounts of loans in Pennsylvania and Texas demonstrates that APR caps are not in consumers’ best interests.

Regulation of Traditional Installment Lenders

All of the federal and state statutes and regulations affecting corporations, partnerships and proprietorships generally apply to traditional installment lenders – including regulations issued by the Federal Trade Commission, the Consumer Financial Protection Bureau, the Federal Reserve Board, the Department of Housing and Urban Development, the Treasury Department, and the Securities and Exchange Commission, and various state regulators. In addition, traditional installment lenders are subject to a multitude of state financial institution statutes, and are regulated in every state in which they operate. In short, states highly regulate the terms and conditions a licensed lender may impose in consumer small loan transactions. Traditional installment lenders are required to follow all state and federal consumer protection laws, and routinely are examined and audited by state agencies and regulators to ensure compliance.

¹⁴ Durkin, Thomas. *Preliminary Findings from the AFSA Member Survey of Installment Lending*. June, 2013. (Included as Appendix A.)

¹⁵ *Ibid.*

Most states' provisions are enforced by a division of the state banking or insurance department, which is frequently empowered to supplement the statutes by enacting rules and regulations. Elsewhere, similar powers rest with other agencies or departments, such as states' departments of commerce or corporations. Finance companies are typically required to be licensed by each state in which they operate. Many states' laws require consumer loan licensees to report regularly (usually annually) on their operations to the state supervisory authorities. In practically all states, annual examinations by these authorities are required by law, and examinations at other times are permitted. The costs of such examinations, in addition to the annual license fee for each operating office, are borne by the licensees in most states.

Refinancing

Loan refinances by traditional installment lenders are based on sound underwriting. In contrast to payday loans, where the loan rolls over if the full amount is not repaid by the due date, traditional installment lenders re-evaluate the borrower's situation, then make a new loan if the borrower demonstrates an ability to repay.

When traditional installment loan borrowers refinance a loan – whether to lower their monthly payment amount or to borrow more money – the lender underwrites a new loan in much the same way that a lender helps a homeowner refinance a mortgage. Consumers are re-evaluated for ability and willingness to repay the loan, and only if the underwriting criteria are met does the refinancing move forward.

Conclusion

Traditional installment lenders provide a responsible form of small-dollar credit for consumers, many of whom would be classified as subprime. Traditional installment loans are fully underwritten considering a consumer's ability to repay and report to credit bureaus. Traditional installment loans are fully amortizing with equal, affordable monthly payments. APRs may seem high compared to other forms of credit, but small-dollar loans cost the same to make as large loans. Traditional installment lenders are commercially sustainable businesses that do not rely on customers' deposits. They are highly regulated in each of the states in which they operate. Ancillary products are sold in conjunction with traditional installment loans, but are optional. The only collateral that traditional installment lenders accept is personal or titled property. When borrowers refinance with traditional installment lenders, a new loan is underwritten.

Again, thank you for the opportunity to provide you with testimony on how the traditional installment loan industry is meeting the small dollar credit needs of millions of Americans in the safest and most affordable manner. If you have any questions please contact AFSA Executive Vice President, Bill Himpler at 202-466-8616 or bhimpler@afsamail.org.