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Challenging Payday Lenders by Opening up the Market for Small-Dollar Loans

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Challenging Payday Lenders by Opening up the Market for Small-Dollar Loans

*Eliza Platts-Mills and Justin Chung**

ABSTRACT

“Why hasn’t someone else stepped in to lend at lower interest rates?” is the question frequently asked in discussions of payday loans. The average payday loan carries an Annual Percentage Rate (APR) of over 300%. Given the strength of the payday lenders lobby at the federal and state level, one way to help low- and moderate-income households escape the financial harms of payday loans is to encourage other lenders to enter the small-dollar loan market and offer more affordable products. Over the past ten years, an array of affordable small-dollar loan programs offered by banks, credit unions, non-profit organizations, and for-profit fintech companies have entered the market to provide borrowers with alternatives to payday loans. These lenders are offering small-dollar loans at rates and on terms that are more manageable for low- and moderate-income consumers than payday loans, while maintaining the features of payday loans that consumers like—namely quick and easy access to credit.

This paper will describe these affordable small-dollar loan programs and explain what is needed from regulators, financial institutions and foundations, and consumer advocates for the programs to serve more borrowers and take over more of the market space currently occupied by payday lenders. Banks, with support from their regulators, can offer affordable small-dollar loans to their customers and should continue to provide low-interest loan capital to non-profit

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small-dollar lenders. Credit unions can continue to offer small-dollar loan programs like the Payday Alternative Loan product and the Employer Sponsored Small-Dollar Loan product and should be encouraged to do so by their regulators. Non-profit organizations can continue to offer affordable loans in partnership with employers or other lenders and should be provided with grants and low-interest loan capital and pro-bono support from lawyers and marketing companies. For-profit, fintech lenders can continue to enter this space and should be supported by consumer advocates and regulators as long as their products meet certain guidelines: compliance with all federal and state laws, affordable payments, and features such as credit bureau reporting, transparent fees, and flexible repayment terms. Finally, recent efforts in Congress to encourage the U.S. Postal Service to offer affordable small-dollar loans should also be supported.

The short-term small-dollar credit needs of low- and moderate-income households should not be met primarily by payday lenders whose high fees and short repayment terms too often trap borrowers in a cycle of debt. Low- and moderate-income consumers deserve better options. With support, the affordable small-dollar loan programs described in this paper can be expanded to make the market for small-dollar credit more competitive, helping borrowers across the country.

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I. INTRODUCTION

Much has been written in the academic press and in the popular media about the urgent need for small-dollar loans for the large number of low- and moderate-income households that have trouble making their income and expenses meet each month.¹ Much has also been written about the harmful impact of payday loans.² There is a vigorous debate among consumer advocates, industry players, and policy makers about whether state and federal regulations are needed to rein in payday lending, or whether regulating payday loans would deny consumers access to a critical source of credit.³ Far less has been written about the market alternatives to payday loans that are emerging, and the successes that these lenders are having extending affordable small-dollar loans to low- and moderate-income borrowers.⁴ This article will describe some of the affordable small-dollar loan programs currently on the market and suggest ways for the public and private sectors to help expand these programs to reach and serve more consumers.

1. See e.g., Neil Bhutta et. al., *Consumer Borrowing After Payday Loan Bans*, 59 J.L. & ECON. 225, 226 (2016) (suggesting that the underlying cause of payday borrowing is a general demand for short-term credit rather than some feature unique to the design or marketing of payday loans); Gillian B. White, *When Payday Loans Die, Something Else Is Going to Replace Them*, ATLANTIC (Oct. 20, 2017), <https://www.theatlantic.com/business/archive/2017/10/payday-loan-occ/543453> (arguing that regulations to curb the supply of payday loans do not address the problem of consumers' demand for small, fast, easy-to-obtain loans).

2. See, e.g., Shane M. Mendenhall, *Payday Loans: The Effects of Predatory Lending on Society and the Need for More State and Federal Regulation*, 32 OKLA. CITY U.L. REV. 299, 306-15 (2007) (discussing how the payday loan industry targets poor and lower-middle-class families entrapping them in the "debt treadmill" and subjecting them to unfair and illegal collection practices); Emily Bazelon, *How Payday Lenders Prey Upon the Poor — and the Courts Don't Help*, N.Y. TIMES (Apr. 18, 2014), <https://www.nytimes.com/2014/04/20/magazine/how-payday-lenders-prey-upon-the-poor-and-the-courts-dont-help.html> (describing how payday lenders prey on the poor and the limits of judicial action against payday lenders).

3. See, e.g., Chris Cirillo, *Payday Loan Regulation: Any Interest?*, 11 DEPAUL BUS. & COMM. L.J. 417, 418 (2013) ("The federal regulations currently in place, combined with specific state regulations . . . can provide a beneficial and fair service to payday loan consumers if utilized in the intended manner"); Paige Marta Skiba, *Regulation of Payday Loans: Misguided?*, 69 WASH. & LEE L. REV. 1023, 1026 (2012) ("Current forms of state and federal regulation of payday lending are largely misguided . . . [M]ost current regulations that restrict access to payday loans do not increase consumers' welfare.").

4. But see Patrick L. Hayes, *A Noose Around the Neck: Preventing Abusive Payday Lending Practices and Promoting Lower Cost Alternatives*, 35 WM. MITCHELL L. REV. 1134, 1157-60 (2009) (discussing alternatives to payday loans offered by banks and credit unions); Michael Kenneth, *Payday Lending: Can "Reputable" Banks End Cycles of Debt?*, 42 U.S.F. L. REV. 659, 662 (2008) (evaluating potential alternatives to mitigate the effects of payday loans including credit unions and banks offering competing products).

This article will refer to the payday loans that emerged in the 1990s and that feature high fees, short terms, and frequent default and rollover as “payday loans” offered by “payday lenders.” This article will refer to the lower-cost, longer-term, more affordable consumer loan alternatives as “affordable small-dollar loans” offered by “affordable small-dollar loan programs.” The marketplace for both payday loans and affordable small-dollar loans will be described as the marketplace for “small-dollar loans.”

Part II of this article explains why each year approximately twelve million low- and moderate-income households in the United States need small-dollar loans and turn to payday lenders. Part III provides a short description of payday loans and the serious financial harm they impose on many of their borrowers. Part IV highlights some of the affordable small-dollar loans currently available to consumers and explains the ways that these small-dollar loans meet some of the market demand described in Part II and avoid the problems described in Part III. Part V concludes with recommendations of specific ways that financial institutions and foundations, regulators, and consumer advocates can provide critical support to these affordable small-dollar loan programs and the low- and moderate-income borrowers they serve. Enabling low- and moderate-income households to access small-dollar loans on more affordable terms will lessen the financial burden these families struggle under and make their lives a little less stressful.

II. THE PERSISTENT NEED FOR SMALL-DOLLAR LOANS

Small dollar loans fill an important market niche in the American economy. Each year, approximately twelve million Americans take out a payday loan. The majority of these payday loan borrowers report annual household income between \$15,000 and \$50,000.⁵ All payday loan borrowers are required to have income, either from a job or from government benefits such as Social Security or disability benefits. Payday loan borrowers are also required to have a bank account, both to receive the loan principle and to repay the loan.⁶ While some borrowers

5. Nick Bourke, Alex Horowitz & Tara Roche, *Payday Lending in America: Who Borrows, Where They Borrow, and Why*, 1 PEW CHARITABLE TR. 48, 35 (2012), https://www.pewtrusts.org/~media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf.

6. *Id.* at 6 (“[Payday] loans are secured by a claim to the borrower’s bank account with a post-dated check or electronic debit authorization”).

use payday loans to cover unexpected, emergency situations, nearly 70% of people who take out payday loans are using the money to cover their basic, monthly living expenses.⁷

Most U.S. households are savings-limited, meaning that they do not have enough liquid assets to cover one month of their living expenses; and the average, low-income household in the United States does not have enough cash or savings to cover even two weeks of its living expenses.⁸ One of the biggest financial challenges facing low-income Americans is unpredictable changes in the amount and timing of their income resulting from irregular hours from employers.⁹ Almost all U.S. households encounter significant dips in income at some point, but families without savings and assets, and without access to a credit card, are not able to weather those ups and downs the same way families with savings, wealth, and credit cards can.

There are three major reasons that low- and moderate-income households in America are unable to save and need regular access to small amounts of short-term credit: (1) flat and falling household income; (2) high and increasing housing costs; and (3) systemic homeownership and credit discrimination against families of color.¹⁰ Household income is not keeping pace with living expenses (particularly housing costs)—contributing factors include employees lacking the necessary education, skills, drive, and support systems to find good jobs, and employers failing to provide enough regular hours at livable wages.¹¹ The U.S. Department of Housing and Urban Development (HUD) estimates that 8.15 million renter and homeowner households in America pay more than 50% of their income on housing, almost two

7. *Id.* at 13.

8. Erin Currier et al., *The Precarious State of Family Balance Sheets*, 1 PEW CHARITABLE TR. 22, 10 (2015), https://www.pewtrusts.org/~media/assets/2015/01/fsm_balance_sheet_report.pdf.

9. Aaron Klein, *Understanding Non-Prime Borrowers and the Need to Regulate Small-Dollar and “Payday” Loans*, BROOKINGS (May 19, 2016), <https://www.brookings.edu/research/understanding-non-prime-borrowers-and-the-need-to-regulate-small-dollar-and-payday-loans/> (citing research from the Center for Financial Strategy Innovation showing income fluctuations as high as 25% below average for almost three months of the year); *see also*, Noam Scheiber, *Marriott Workers Struggle to Pay Bills, and Credit Union Fees*, N.Y. TIMES (Oct. 11, 2018), <https://tinyurl.com/y9rjyecf> (describing Marriott’s failure to give its employees full hours).

10. Currier, *supra* note 8, at 2–3, 6–7; RICHARD ROTHSTEIN, *THE COLOR OF LAW: A FORGOTTEN HISTORY OF HOW GOVERNMENT SEGREGATED AMERICA* 59–76, 153–76 (2017).

11. *See generally* Klein, *supra* note 9; Currier, *supra* note 8, at 2–3, 6–7.

times the 30% of income that HUD considers “affordable” for households to spend on housing.¹²

It would be ideal if low- and moderate-income families could balance their budgets every month, put aside some money for savings, and not need small-dollar loans. Employers should be pressured to provide full-time jobs with regular, full-time hours and livable wages. Federal, state, and local governments, the non-profit sector, and the private, for-profit sector should support and fund job training programs, affordable housing programs, and programs that help individuals and families move to find better jobs. In the meantime, while income continues to fall behind or only just barely meet monthly expenses for many families, the need for small-dollar loans continues, and alternatives to payday loans should be supported.

III. THE FINANCIAL HARM DONE BY PAYDAY LOANS

Payday lenders comprise an estimated \$40 billion to \$50 billion, omnipresent, highly visible, politically powerful industry.¹³ The payday loan product, which emerged in the 1990s and is used by more than twelve million U.S. households each year, is an extremely expensive form of credit.¹⁴ Payday loans typically feature annual interest rates greater than 300% and short repayment terms.¹⁵ While payday loans used to feature a very short, two-week term, designed to match a borrower’s payday period, payday lenders are now offering non-amortizing, installment loans with terms longer than forty-five days in response to the Consumer Financial Protection Bureau’s (CFPB) new payday lending rule.¹⁶ The new CFPB rule, which will go into effect

12. Nicole Elsasser Watson et al., *Worst Case Housing Needs: 2017 Report to Congress*, 1 U.S. DEP’T OF HOUS. & URB. DEV. OFF. OF POL’Y DEV. & RES. 92, 3, 13 (2017), <https://www.huduser.gov/portal/sites/default/files/pdf/Worst-Case-Housing-Needs.pdf>.

13. Nathalie Martin, *1000% Interest—Good While Supplies Last: A Study of Payday Loan Practices and Solutions*, 52 ARIZ. L. REV. 563, 570, 595 (2010).

14. *Payday Loan Facts and the CFPB’s Impact*, PEW CHARITABLE TR. (Jan. 14, 2016), <https://www.pewtrusts.org/en/research-and-analysis/fact-sheets/2016/01/payday-loan-facts-and-the-cfpbs-impact>.

15. Christine L. Dobridge, *For Better and for Worse? Effects of Access to High-Cost Consumer Credit 7* (Finance and Economics Discussion Series 2016-056. Washington: Board of Governors of the Federal Reserve System, 2016), <http://dx.doi.org/10.17016/FEDS.2016.056>.

16. See Gillian B. White, *When Payday Loans Die, Something Else is Going to Replace Them*, ATLANTIC (Oct. 20, 2017), <https://www.theatlantic.com/business/archive/2017/10/payday-loan-occ/543453/>; see also Gail MarksJarvis, *Installment Loans Just as Risky as Payday Loans, Pew Warns*, CHI. TRIB. (Aug. 11, 2016, 3:39 AM), <http://www.chicagotribune.com/business/ct-payday-loans-rules-pew-0812-biz-20160811-story.html>.

in 2019 unless changed before then, applies to payday and auto-title loans with terms of *less than* forty-five days, and requires lenders to cap rollovers, limit repeated attempts to debit a borrower's bank account, and make an up-front determination of a borrower's ability to repay the loan. In response, payday lenders have created installment loan products with terms longer than forty-five days and with the same high interest rates and fees.

A payday loan is commonly described as a high-interest loan for a small amount of money with the lender using a post-dated check or electronic access to the borrower's checking account as collateral.¹⁷ Many state lending laws permit payday lenders to charge high-interest rates; other states impose interest rate ceilings.¹⁸ In Texas, payday lenders get around state law interest rate caps by charging relatively low interest rates combined with high fees both for the initial loan and for subsequent rollovers or renewals of that first loan.¹⁹ For example, both the Texas Constitution and the Texas Finance Code set the usury rate at 10%.²⁰ Lenders in Texas who wish to charge interest rates above 10% are required to be licensed and regulated by the Texas Office of Consumer Credit Commissioner and are subject to interest rate caps of 18% to 30%.²¹ To avoid these interest rate regulations, payday loans in Texas are issued by an in-state company that originates the loan at 10% or less, and the loan is administered by a separate, unaffiliated organization, regulated as a credit services organization, that charges high fees that are not subject to any state caps.²² Payday loans can be described as high-interest loans because the accepted metric for describing loans is the Annual Percentage Rate (APR), which is the combination of interest *and* fees associated with a loan, calculated over a twelve-month period.²³

17. Bourke, Horowitz & Roche, *supra* note 5, at 6.

18. See Heather Morton, *Payday Lending State Statutes*, NCSL (Jan. 23, 2018), <http://www.ncsl.org/research/financial-services-and-commerce/payday-lending-state-statutes.aspx>.

19. Sealy Hutchings & Matthew J. Nance, *Credit Access Businesses: The Regulation of Payday and Title Loans in Texas*, 66 CONSUMER FIN. L.Q. REP. 76, 77, 79 (2012).

20. See TEX. CONST. art. XVI, § 11; TEX. FIN. CODE § 324.004.

21. See TEX. FIN. CODE § 342.

22. See *Lovick v. Ritemoney Ltd.*, 378 F.3d 433, 443–44 (5th Cir. 2004) (holding that fees charged by credit-service organizations are not limited by Texas usury laws or laws requiring reasonable broker fees).

23. *Annual Percentage Rate*, BUSINESS DICTIONARY, <http://www.businessdictionary.com/definition/annual-percentage-rate-APR.html> (last visited Nov. 8, 2018).

Many payday lenders advertise their loans as bearing \$15 in fees for every \$100 borrowed.²⁴ To some borrowers, \$15 in fees per \$100 borrowed appears to be an interest rate of 15% ($\$15/\100), which would be comparable to a credit card and to some of the small-dollar loan programs described in Part IV below. However, \$15 in fees per \$100 borrowed does not result in a 15% APR if the loan term is two weeks instead of one year. Instead, \$15 in fees for \$100 borrowed, when calculated over a twelve-month period to get an *annual* percentage rate results in a 391% APR ($\$15/\$100 = .15 \times 365 = 54.74/14 = 3.91 \times 100 = 391$).²⁵ This extremely high interest rate begs the opening question in this article of why more lenders have not entered the market to offer small-dollar loans on more affordable terms.

There is a common misconception that payday loan borrowers are turning to payday loans because they are unbanked, a term used to describe individuals who have neither a checking account nor a savings account with a bank. In fact, payday lenders *require* their borrowers to have a bank account. Before a borrower can receive a payday loan, the borrower must give the lender electronic access to their checking account or a post-dated check for the full amount of the loan plus the fee. Once the payday lender has access to the borrower's bank account, either through the electronic funds transfer authorization or the post-dated check, the payday lender immediately gives the borrower the full amount of the loan without further inquiry into the borrower's ability to repay. The goal of the payday lender is to provide consumers quick and easy access to cash. If the borrower cannot repay the loan when it is due, which is the situation with over 80% of payday loans, the payday lender permits the borrower to renew the initial loan, typically for another fee in equal amount to the initial fee.²⁶ This pattern repeats itself

24. Bethany McLean, *Payday Lending: Will Anything Better Replace It?*, ATLANTIC (May 2016), <https://www.theatlantic.com/magazine/archive/2016/05/payday-lending/476403/>.

25. *APR Calculation Formula*, MISSOURI DIVISION OF FINANCE, <https://finance.mo.gov/consumercrredit/apr.php> (last visited Nov. 8, 2018) (APR calculation formula = "FEE (Origination fee + Interest) divided by AMOUNT FINANCED divided by NUMBER OF DAYS OF TERM OF NOTE multiplied by 365 multiplied by 100 . . ."); *see also*, Sheila Bair, *Low-Cost Payday Loans: Opportunities and Obstacles*, 1 ANNIE E. CASEY FOUND. 89, 35 (June 2005), <https://www.cfsponline.com/uploads/LowCostPaydayLoans.pdf> (arguing that mandatory disclosures should include both the APR and the cost per \$100, to enable consumers to more easily compare loan products).

26. Kathleen Burke et al., *CFPB Data Point: Payday Lending*, 1 CONSUMER FIN. PROT. BUREAU 33, 4 (2014), https://files.consumerfinance.gov/f/201403_cfpb_report_payday-lending.pdf (stating that half of all loans are renewed for at least ten two-week cycles, incurring additional renewal fees each time).

to the financial harm of the borrower and the financial benefit of the payday lender. Because nearly 70% of payday loan borrowers are in need of immediate cash to meet their everyday living expenses and have no savings or other source from which to borrow money, these borrowers are unlikely to have enough income to be able to repay the loan in full when it is due.²⁷ These consumers are offered credit under terms, especially the length of the loan, that virtually guarantee default or renewal of the loan.²⁸

IV. MARKET ALTERNATIVES: AFFORDABLE SMALL-DOLLAR LOANS

In the past ten years, more affordable market alternatives to payday loans have emerged. These loan products are the result of three, quite different, forces.

First, some financial institutions, including both banks and credit unions, have entered the market as part of pilot programs initiated by regulators or trade union associations, or on their own initiative. These financial institutions realize that a good number of their account holders need small-dollar loans and see the long-term advantage of providing small-dollar loans to borrowers who may one day come back for a much larger loan.²⁹ They typically have boards of directors or other influential members of management who believe that providing affordable small-dollar loans is the right thing to do.³⁰ Some banks also provide small-dollar consumer loans as part of their required, annual Community Reinvestment Act (CRA) commitments to low- and moderate-income families and neighborhoods.³¹ Some credit unions pride themselves on being low-income, community-based credit unions whose mission is to provide financial products tailored to their low- and moderate-income borrowers.³²

27. Bourke, Horowitz & Roche, *supra* note 5, at 13.

28. Burke, *supra* note 26, at 4.

29. *A Template for Success: The FDIC's Small-Dollar Loan Pilot Program*, 4 FDIC Q. 28, 32 (2010) [hereinafter *A Template for Success*].

30. *Id.*

31. The CRA is a 1977 federal law which covers national and state banks and savings associations whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC) and requires these institutions to lend to, invest in, or serve low- and moderate-income households and neighborhoods in their service areas. 12 U.S.C.A. § 2901 (West 2009). Federal regulators conduct annual CRA examinations of covered institutions, and a poor result can be used to reject an institution's application to expand or merge. *Id.*

32. Telephone Interview with Larry Garcia, Mountain Star Federal Credit Union (Apr.

Second, non-profit, charitable organizations have entered the market as a response to the urgent needs of their low-income clients for affordable small-dollar loan products, and after realizing that financial education and legislative reform, while helpful and important, are not sufficient by themselves when their clients need immediate access to credit to pay their monthly bills. These non-profit lenders typically rely on low-interest loans or grants from foundations and banks to raise the necessary loan capital. Some of the banks that are not doing direct small-dollar lending themselves earn CRA credit by extending loan capital to these non-profit lenders. Non-profit organizations, much like credit unions, have found success with employer-based loan programs, in which the loan product is offered as a voluntary benefit to borrowers employed by participating employers.

Third, some start-up financial technology (“fintech”) companies have entered the market in an attempt to take market share away from payday lenders and ameliorate the harms of payday lending. Fintech companies raise money from the private sector and, because they need to meet higher rates of return for these private market investors, offer rates that are higher than the small-dollar loan programs offered by banks, credit unions, and non-profit lenders but lower than payday loans. Federal and state consumer protection agencies and consumer advocates need to monitor these for-profit lenders to ensure they are keeping their promises and to help borrowers identify the good fintech lenders.

In addition, a bill has been introduced in the Senate that would allow the U.S. Postal Service to provide small-dollar loans. The U.S. Postal Service already has brick and mortar locations throughout urban and rural America and the trust of borrowers. This option should be explored further and supported.

Regardless of the affordable small-dollar lender’s motive, the affordable small-dollar loans now on the market are providing some consumers with access to small amounts of credit at affordable rates. To date, these alternative, affordable small-dollar loan programs are not nearly as ubiquitous as payday loans, are not yet available in many geographic areas, and are further limited by employer, by credit union,

20, 2018); Scheiber, *supra* note 9 (describing the differences among credit unions in their approaches to providing affordable financial products to their low-income workers).

and sometimes by credit history. However, they are growing in number and size, and collectively they can make a difference for many. Each of these alternative lenders should be supported and encouraged.

A. Financial Institutions and Affordable Small-Dollar Loans

Banks and credit unions are well-positioned to succeed in the small-dollar loan market because they are already in the business of extending credit, have access to loan capital, have existing customers who are using payday loans, and have a pervasive regional or national presence.³³ However, banks are under pressure from their shareholders to maximize profits, and both banks and credit unions are under pressure from their regulators to carry adequate reserves and engage in responsible underwriting. In addition, as described in more detail below, although free to charge higher rates, banks are reluctant to charge the interest rates that they would need to charge to make small-dollar loans profitable, for fear of being stigmatized as payday lenders. Banks and many credit unions would also need to devote significant resources, including developing community partners, to build trust with small-dollar borrowers. It is worth noting that credit unions are in a slightly different posture from banks because they are exempt from paying federal income taxes and not included in the coverage of the CRA, on the assumption that their mission is to provide affordable financial services to their members. With a few notable exceptions described below, neither banks nor credit unions are as engaged in the small-dollar loan market as would be ideal for borrowers; but there are recent signs that that may be changing, as discussed below.

1. Banks should offer small-dollar loans themselves and should continue to provide low-interest loan capital to other small-dollar lenders

Banks are well-positioned to offer lower-cost alternatives to payday loans because of operational advantages they have over payday

33. For this paper, “banks” refers to retail commercial banks chartered under either federal or state law and regulated by the Office of the Comptroller of the Currency, the Federal Reserve System, or the Federal Deposit Insurance Corporation, and includes public and private banks and banks with either a national or regional reach. For this paper, “credit unions” refers to credit unions chartered under either federal or state law and regulated by the National Credit Union Administration, and includes credit unions with either a national or regional reach.

lenders. Banks may also avoid state interest rate ceilings by being headquartered in a state without a usury cap. This ability to evade state interest rate caps allows a bank to charge an appropriate interest rate on a small-dollar loan product to compensate for the risks and expenses of offering the product.³⁴ Yet, banks have historically been reluctant to provide affordable small-dollar loans. There are hopeful, recent signs that banks may be entering this market, with support from the CFPB, the Office of the Comptroller of the Currency (“OCC”), and other federal banking regulators, as explained below.

a. Operational advantages of banks. Banks could provide lower-cost alternatives to payday loans because they have an infrastructure in place that can minimize operational costs. Banks already have facilities, staff, and collection processes in place. Banks also have an existing customer base to which they can market a lower-cost loan product, and 81% of payday loan customers state that, if eligible, they would prefer to borrow from a bank or credit union than from a payday lender.³⁵ Banks already have access to their customers’ accounts so, unlike payday lenders, they would not have to coordinate with another financial services provider to collect on the loan. Finally, banks derive their income from a variety of products and services allowing them to tap other revenue streams to develop and market the product and to withstand the potentially high initial loan charge-off rate while they determine the appropriate interest rate. As a result, banks are in a favorable position to provide small-dollar loans at a lower cost than payday lenders.³⁶

Additionally, national and state banks can avoid state interest rate ceilings. The National Banking Act preempts state usury laws, allowing national banks to charge a higher interest rate than state law allows.³⁷ The U.S. Supreme Court has held that the National Banking Act allows national banks to be governed by the usury limitation, or lack of limitation, of their home states when making loans to customers in a different state.³⁸ States, starting with South Dakota and Delaware,

34. Bair, *supra* note 25, at 34 (suggesting that if depository institutions can match payday lenders’ speed and convenience with a lower priced product, they could capture significant market share).

35. Nick Bourke et. al., *Payday Loan Customers Want More Protections, Access to Lower-Cost Credit from Banks*, 1 PEW CHARITABLE TR. 24, 6 (2017), <https://www.pewtrusts.org/-/media/assets/2017/04/payday-loan-customers-want-more-protections.pdf>.

36. Hayes, *supra* note 4, at 1157.

37. National Banking Act, 12 U.S.C.A. § 85 (West 1980).

38. *Marquette Nat’l Bank of Minneapolis v. First of Omaha Serv. Corp.*, 439 U.S. 299

began eliminating their usury limits in order to attract banks to their states. As a result, many national banks moved their headquarters to states without usury limits in order to export the lack of an interest rate ceiling and charge customers any interest rate they like, regardless of the usury laws of the state in which the loan is made. State chartered banks,³⁹ arguing unfair competition from nationally chartered banks, lobbied Congress for the same right, which Congress granted in 12 U.S.C. § 1831(d) (2002). National and state banks could, thus, offer a small-dollar loan product without being subject to state usury laws.⁴⁰

Despite these advantages, mainstream financial institutions, including the major national retail banks, have for the most part failed to meet the needs of low- and moderate-income families for small-dollar loans. Most banks say that they cannot make the numbers work with small-dollar loans because the back-office expenses of a \$1000 loan are the same as those for a much larger loan, while the interest that can be made on the smaller loan is not nearly as large. Bank officials consider payday loans to be high-risk products that require extremely high interest rates to maintain profitability. Banks perceive payday loans as unfeasible because of the high transaction costs in servicing and underwriting the loans.⁴¹ Additionally, offering loans at high interest rates in order to compensate for risks and costs opens up banks for criticism from public policy officials, the media, and consumer advocates. The risk of harming their reputations may be keeping banks away from the market despite the knowledge that they are foregoing a multi-billion-dollar business.⁴² Banks also need guidance and support from their regulators.⁴³

(1978).

39. State chartered banks are organized under state law. They can, but do not have to, be a member of the Federal Reserve. State chartered banks that are members of the Federal Reserve are primarily regulated by the Federal Reserve. State chartered banks that are not members of the Federal Reserve are primarily regulated by the FDIC. Nationally chartered banks, on the other hand, are organized under federal law, including the National Banking Act. Nationally chartered banks are required to be members of the Federal Reserve and are primarily regulated by the OCC. See Harry Sit, *What Type of Bank Is Your Bank?*, FIN. BUFF (Oct. 2, 2007), <https://thefinancebuff.com/what-type-of-bank-is-your-bank.html>.

40. Nathalie Martin, *Public Opinion and the Limits of State Law: The Case for A Federal Usury Cap*, 34 N. ILL. U. L. REV. 259, 264–65 (2014).

41. Michael Bertics, *Fixing Payday Lending: The Potential of Greater Bank Involvement*, 9 N.C. BANKING INST. 133, 153 (2005).

42. Kenneth, *supra* note 4, at 703-04.

43. See Nick Bourke, *How CFPB Rules Can Encourage Banks and Credit Unions to Offer Low-Cost Small Loans*, PEW CHARITABLE TR. (Apr. 5, 2016), <https://www.pewtrusts.org/en/research-and-analysis/articles/2016/04/05/how-cfpb-rules-can-encourage-banks-and-credit-u>

b. The FDIC's template for banks to issue small-dollar loans. The Federal Deposit Insurance Corporation (FDIC) has developed a template for banks that wish to make small-dollar loans.⁴⁴ In June 2007, the FDIC announced guidelines for a two-year, small-dollar loan pilot program to evaluate whether banks could offer affordable and profitable small-dollar loan programs. The guidelines noted that the high use of payday loans and fee-based, overdraft programs by individuals with checking accounts at banks was a red flag to the banks that their customers need affordable small-dollar loans. The FDIC pilot program ran from December 2007 to December 2009, and twenty-eight banks, with total assets ranging in size from \$28 million to \$10 billion, and together having more than 450 offices in twenty-seven states, participated in the program. The small number of banks that participated in the pilot program and the fact that few banks continued offering small-dollar loans after the pilot program indicate that banks need more support and encouragement than they received in the pilot program.

The FDIC provided each bank participating in the pilot program with guidelines (“Affordable Small-Dollar Loan Guidelines”) for how to implement a small-dollar loan product and permitted banks some flexibility to encourage innovation.⁴⁵ At the end of the pilot program, based on the experience of the participant banks, the FDIC created a template for banks entering the small-dollar loan space. The template, “A Safe, Affordable, and Feasible Template for Small-Dollar Loans,” incorporates lessons learned during the pilot program and copies features of the payday loan process that are important to borrowers seeking frictionless access to credit, such as a quick credit decision.⁴⁶ The template requires an APR of 36%⁴⁷ or less, a loan term of ninety days

nions-to-offer-lower-cost-small-loans [hereinafter Bourke, *How CFPB Rules Can Encourage Banks*]; see also *Standards Needed for Safe Small Installment Loans from Banks, Credit Unions*, 1 PEW CHARITABLE TR. 10 (2018), https://www.pewtrusts.org/-/media/assets/2018/02/standards_needed_final.pdf.

44. *A Template for Success*, *supra* note 29.

45. *Id.* at 29.

46. *Id.*

47. The 36% APR cap is frequently used as a benchmark for payday lending reforms. In addition to the FDIC pilot program, Congress approved a 36% rate cap on loans offered to active duty members of the military and their dependents in the Military Lending Act of 2006. The 36% benchmark comes from the advocacy of the Russell Sage Foundation and fellow reform groups in the early 20th century when a black market for illegal usurious small loans thrived. The Russell Sage Foundation was successful in getting thirty-four states to adopt versions of the Uniform Small Loan Law with interest rate caps of around 36%. See Lauren K. Saunders, *Why 36%? The History, Use, and Purpose of the 36% Interest Rate Cap*, 1 NAT'L CONSUMER LAW CTR. 14 (2013), <https://www.nclc.org/images/pdf/pr-reports/why36pct.pdf>. While many civil

or greater, and a loan decision within twenty-four hours of the borrower's application.

The results of the FDIC pilot program demonstrate that banks can offer small-dollar loans that are commercially sustainable, albeit not as profitable as other products they offer. Overall, the banks participating in the pilot program originated over 34,400 loans, totaling \$40.2 million in extended credit. The loans were made at interest rates ranging from 13% to 16%, with administrative fees that ranged from \$31 to \$46. When fees are combined with interest rates, the average APR for these loans was safely below the 36% cap set in the FDIC's pilot program guidelines.⁴⁸ The thirty-day delinquency rates for the loans, capturing the number of loan repayments that were thirty or more days late, were high, and markedly higher than comparable, unsecured small-dollar loan products offered by the same banks. Specifically, in the fourth quarter of 2009, the average thirty-day delinquency rate for the small-dollar loans was 11%, as compared with 2.5% for similar unsecured, small-dollar loan products. The banks' charge-off ratios⁴⁹ in the pilot program were similar to the industry average: 6.2% as of the fourth quarter of 2009 for small-dollar loans in the pilot program, as compared with 5.4% for the fourth quarter of 2009 for similar unsecured loans to individuals.

Banks in the FDIC program reported that the profits on the small-dollar loan programs were not as high as the profits from their other products and that they used the small-dollar loan program to create goodwill in the community and to cultivate relationships with borrowers who might eventually demand higher profit products from the bank. The FDIC reported that the participating banks requested the flexibility to issue "nearly small-dollar loans" (consumer loans with loan amounts between \$1000 and \$2500) in addition to "small-dollar loans" (consumer loans with loan amounts of up to \$1000), both because their customers were demanding these loans and because these loans brought in more revenues to the bank and cost the same amount to originate and service. The FDIC template permits loans of up to

rights and consumer rights organizations still advocate for the 36% APR cap, limiting monthly installment payments to 5% of gross monthly income is emerging as an alternative measure of affordability. *See infra*, text accompanying note 71.

48. *A Template for Success*, *supra* note 29, at 28, 30.

49. "Charge-off" refers to outstanding debt that the creditor has deemed uncollectible because the borrower has become substantially delinquent after a period of time. *See Charge-off*, INVESTOPEDIA, <https://www.investopedia.com/terms/c/chargeoff.asp> (last visited Nov. 8, 2018).

\$2500 to capture the banks' stated interest in being able to extend both small-dollar loans and nearly small-dollar loans.⁵⁰

While the FDIC's pilot program limited loans to APRs below 36%, banks are free to offer small-dollar loans at higher rates in the open market if they are headquartered in states without interest rate caps. Higher interest rates could be used to offset the costs of the product. However, the presumption of high risk justifying high interest rates may be questioned. Loan losses for payday loans may not be significantly higher than those associated with other financial products.⁵¹ By charging high interest rates, payday lenders operate at high margins, with one professor of economics suggesting that payday lenders earn returns on equity at ten to twenty times the rates of traditional banks.⁵² The discrepancy between returns on equity suggests a market opportunity for banks. However, the difficulty of finding an appropriate interest rate that both allows the product to be profitable while maintaining goodwill in the community and cultivating relationships with borrowers may explain the reluctance of banks to enter the small-dollar loan market without additional support from their regulators.

c. Banks benefit from the payday loan industry. It is important to note that banks benefit financially from the payday loan industry. To qualify for a payday loan, consumers must have a bank account, both as a place for the payday lender to deposit the principal amount of the loan and as a source of repayment of the loan, whether by postdated check or electronic funds transfer authorization. Banks collect fees related to the set up and maintenance of these checking and savings accounts, and when payday lenders attempt to collect a payment from a bank account with insufficient funds, banks collect overdraft and insufficient funds fees from the borrower of \$35 per transaction.⁵³ While

50. *A Template for Success*, *supra* note 29, at 28, 30.

51. Kenneth, *supra* note 4, at 688 (citing Paul Chessin, *Borrowing from Peter to Pay Paul: A Statistical Analysis of Colorado's Deferred Deposit Loan Act*, 83 DENV. U. L. REV. 387, 408 (2005) (finding charge-off rates for payday loans comparable to those for loans from commercial banks and less than those for credit cards)); Michael A. Stegman & Robert Faris, *Payday Lending: A Business Model that Encourages Chronic Borrowing*, 17 ECON. DEV. Q. 8, 23 (2003) (finding charge-offs had a minor impact on profits compared to the convenience and location of the store).

52. Kenneth, *supra* note 4, at 689 (citing Steven M. Graves & Christopher L. Peterson, *Predatory Lending and the Military: The Law and Geography of "Payday" Loans in Military Towns*, 66 OHIO ST. L.J. 653, 664 (2005)).

53. Jean Ann Fox, 2011 CFA Survey of Big Bank Overdraft Loan Fees and Terms, 1 CONSUMER FED'N OF AMERICA 5, 1 (2011), <https://consumerfed.org/pdfs/OD-14BankSurvey-ChartAugust2011.pdf>.

Regulation E of the Electronic Fund Transfers Act prohibits lenders, including financial institutions and non-profit and for-profit lenders, from conditioning consumer credit on the borrower agreeing to repay by preauthorized electronic funds transfer, there is an express exception for credit extended under an overdraft credit plan.⁵⁴

In August 2017, the Consumer Financial Protection Bureau reported that banks and credit unions collected an estimated \$15 billion in overdraft and bounced check fees in 2016, with an average overdraft amount of just over \$20 and an average overdraft “protection” fee of \$34.⁵⁵ In fact, the APR on these overdraft fees is even higher than the high APRs on payday loans.⁵⁶

d. Banks previously offered payday loans. While most of the blame for payday loans falls on the private corporations that dominate the payday loan industry—Advance America, Cash America, Ace Express, etc.—some of the biggest U.S. banks also offered the equivalent of payday loans until sufficient pressure was brought to bear for them to end this practice. These products, instead of being called payday loans, were marketed as “deposit advance” loans and carried fees and terms that were almost identical to those offered by payday lenders.⁵⁷ Specifically, Wells Fargo marketed a “Direct Deposit Advance”; U.S. Bank offered a “Checking Account Advance”; Regions Bank had a “Ready Advance”; Fifth Third Bank had an “Early Access” product; Bank of Oklahoma and its affiliate banks had a “Fast Loan” product; and Guaranty Bank had an “Easy Advance.”⁵⁸

In November 2013, the Office of the Comptroller of Currency (OCC) issued guidance regarding deposit advance products stating that the OCC would take supervisory action to “address any unsafe or unsound banking practices associated with these products, to prevent harm to consumers, and to ensure compliance with all applicable

54. 12 C.F.R. § 205.10(e) (2017) (“No financial institution or other person may condition an extension of credit to a consumer on the consumer’s repayment by preauthorized electronic fund transfer, except for credit extended under an overdraft credit plan or extended to maintain a specified minimum balance in the consumer’s account.”).

55. David Low et al., *Data Point: Frequent Overdrafters*, 1 CONSUMER FIN. PROT. BUREAU 50, 32 (2017), https://files.consumerfinance.gov/f/documents/201708_cfpb_data-point_frequent-overdrafters.pdf.

56. *Id.*

57. See Rebecca Borné & Peter Smith, *Triple-Digit Danger: Bank Payday Lending Persists*, 1 CTR. FOR RESP. LENDING 2, 2 (2013), <https://www.responsiblelending.org/payday-lending/research-analysis/Triple-Digit-Bank-Payday-Loans-Summary.pdf>.

58. *Id.*

laws.”⁵⁹ OCC examiners would assess the credit quality of consumers, adequacy of capital, reliance on fee income, and adequacy of allowance for loan losses.⁶⁰ On the whole, the 2013 OCC guidance made it more difficult for banks to offer deposit advance products. The guidance remained in place for almost four years until it was rescinded in October 2017, with the OCC arguing that banks could “serve consumers’ needs for short-term, small-dollar credit” and needed more flexibility to offer alternatives to “less-regulated lenders.”⁶¹ The change in guidance by the OCC has opened up the possibility for nationally chartered banks to offer affordable deposit advances, while state-chartered banks are still subject to FDIC supervision on the product.⁶²

e. The OCC issues helpful guidance for small-dollar installment loans and U.S. Bank introduces its Simple Loan. On May 23, 2018, the OCC published OCC Bulletin 2018-14, entitled “Core Lending Principles for Short-Term, Small-Dollar Installment Lending.” The Bulletin sets out an illustrative list of loan features of short-term, small-dollar installment loans that it considers to be reasonable policies and practices.⁶³ The list includes: loan amounts and repayment terms that are affordable and reasonable for the particular borrower; loan pricing that complies with applicable state laws and is reasonably related to costs and risk; underwriting based on ability to repay not just traditional credit scoring; flexible loan servicing that works with borrowers who need reasonable workout strategies; and timely reporting to credit borrowers to enable borrowers to build or rebuild their credit.⁶⁴ The OCC’s announcement has been heralded by some consumer advocates for giving mainstream financial institutions the regulatory support they need to offer affordable small-dollar loans.⁶⁵

59. Guidance on Supervisory Concerns and Expectations Regarding Deposit Advance Products, 78 Fed. Reg. 70624 (Nov. 26, 2013).

60. *Id.* at 624.

61. U.S. DEP’T OF THE TREASURY, RESCISSION OF GUIDANCE ON SUPERVISORY CONCERNS AND EXPECTATIONS REGARDING DEPOSIT ADVANCE PRODUCTS (2017).

62. *Id.*; Joe Adler et al., *As CFPB Closes Door on Payday, OCC Opens One for Deposit Advance*, AM. BANKER (Oct. 5, 2017, 1:56 PM), <https://www.americanbanker.com/news/as-cfpb-closes-door-on-payday-occ-opens-one-for-deposit-advance>.

63. U.S. DEP’T OF THE TREASURY, CORE LENDING PRINCIPLES FOR SHORT-TERM, SMALL-DOLLAR INSTALLMENT LENDING (2018).

64. *Id.*

65. Nick Bourke, *Momentum Is Building for Small-Dollar Loans*, AM. BANKER (Sept. 12, 2018, 10:22 AM), <https://www.americanbanker.com/opinion/momentum-is-building-for-small-dollar-loans> [hereinafter Bourke, *Momentum Is Building for Small-Dollar Loans*]; *but see* Rebecca Borne, *High-Cost Bank Loans a Step in the Wrong Direction*, AM. BANKER (Oct. 3, 2018, 10:13 AM), <https://www.americanbanker.com/opinion/high-cost-bank-loans-a-step-in-the>

On September 10, 2018, U.S. Bank, the fifth largest commercial bank in the United States, announced that it will offer a new, small installment loan with monthly payments of no more than 5% of a borrower's monthly income.⁶⁶ The loan, called a Simple Loan, can be in an amount of \$100 to \$1000, repayable over three months in three, equal payments, with fees of \$12 per \$100 borrowed if repaid by electronic funds transfer from a checking account or \$15 per \$100 if not, and no late fees, missed-payment fees, or prepayment penalties.⁶⁷ When applied over a loan term of three months, a fee of \$15 per \$100 borrowed represents an APR of 61% ($\$15/\$100 = .15 \times 365 = 54.74/90 = .61 \times 100 = 61$). In order to apply for a Simple Loan, a prospective borrower must first open a checking account with U.S. Bank, have that checking account for six months, and establish at least a three-month track record of making payments into the account, either from paychecks or Social Security payments.⁶⁸ Loan applications are evaluated and, if approved, funded within minutes, with U.S. Bank pulling a credit report to evaluate the applicant's ability to repay.⁶⁹ Borrowers may only take out one Simple Loan at a time and must wait for thirty days after repayment of one loan before taking out a subsequent loan.

While there is criticism from some consumer advocates that the Simple Loan carries an APR above 36% and therefore above many state consumer lending laws,⁷⁰ a 61% APR is significantly below the much higher APRs of payday loans and may be what is needed for

wrong-direction (arguing that the best way to ensure affordability is an interest rate cap of 36%); Letter to Federal Regulators from Civil Rights and Consumer Rights Organizations (May 14, 2018), <https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-bank-usury-joint-regulators-4may2018.pdf> (urging regulators that "all financial institutions engaged in small-dollar lending (1) limit interest rates to 36% or less, and (2) determine borrowers' ability to repay their loans by assessing both income and expenses rather than engaging in collateral-based income-only underwriting.").

66. *Small-Dollar Loans Made Simple*, U.S. BANK (Sept. 10, 2018), <https://www.us-bank.com/newsroom/stories/small-dollar-loans-made-simple.html>.

67. *U.S. Bank Launches Simple Loan to Meet Customers' Short-Term Cash Needs*, BUS. WIRE (Sept. 10, 2018, 10:30 AM), <https://www.businesswire.com/news/home/20180910005578/en/U.S.-Bank-Launches-Simple-Loan-Meet-Customers%E2%80%99>.

68. See Russ Wiles, *This Payday-Like Loan Is Brought to You by . . . a Bank?*, ARIZ. REPUBLIC (Sept. 23, 2018, 6:00 AM), <https://eu.azcentral.com/story/money/business/consumer/2018/09/23/us-bank-offers-payday-loans-and-slammed-critics/1307168002/>.

69. *Id.*

70. See e.g., Borne, *supra* note 65.

banks to enter the affordable small-dollar loan market and start to displace payday loans.⁷¹

Rather than offering small-dollar loans with interest rates and fees comparable to payday lenders, banks could and should enter the small-dollar loan market with rates that work for the banks but are more affordable than payday loans. The OCC and U.S. Bank appear to be setting a good example, and hopefully other banks and regulators will follow their lead.

f. Examples of other small-dollar loan programs offered by banks. Spring Bank is an FDIC-insured community bank in New York City that has obtained both a Community Development Financial Institutions (CDFI) designation for lending and investing in low- and moderate-income communities and a B-Corp⁷² designation for having a double bottom line that includes financial inclusion and credit building for unbanked and underbanked consumers outside the financial mainstream.⁷³ Spring Bank offers its customers more affordable financial products including several affordable small-dollar loans. One option is a Spring Bank Employee Opportunity Loan of \$1000 to \$2500, with a 16% APR and a term of twelve months, with no minimum credit score requirement, payments automatically deducted from the employee's paycheck, and no financial commitment for participant employers. Another option is a Spring Bank Start Loan of \$1000 to \$1500, with a 16% APR and a term of twelve months, with no minimum credit score requirement.⁷⁴

Elastic, a line of credit offered by Republic Bank, a Louisville, Kentucky-based bank, is an example of a small-dollar loan product offered

71. See e.g., *Standards Needed for Safe Small Installment Loans from Banks, Credit Unions*, *supra* note 43 (advocating for affordable installment payments of no more than 5% of a borrower's gross paycheck, double-digit APRs that decline as the amount borrowed increases, total costs of no more than half of loan principal, loan payments that cannot trigger overdraft or insufficient funds fees, online or mobile application with automated loan approval to ensure speedy access to credit, and reporting to credit bureaus).

72. B-Corp designation is a seal of good corporate housekeeping awarded by a non-profit organization named B-Lab, which evaluates applications from corporations that seek the designation based on their commitment to meeting standards of "social and environmental performance, public transparency, and legal accountability." See *About B Corps*, CERTIFIED B CORP., <https://bcorporation.net/about-b-corps> (last visited Nov. 8, 2018).

73. *Our Story*, SPRING BANK, <https://springbankny.com/our-story/> (last visited Nov. 8, 2018).

74. *Personal Lending*, SPRING BANK, <https://springbankny.com/personal-lending/> (last visited Nov. 8, 2018).

by a bank with rates higher than 36% but far lower than payday lenders. Upon approval following a credit check, borrowers receive a \$500 to \$3500 credit line and can borrow as little as \$20 or as much as their credit line. Elastic encourages responsible lending through an enforced cooling off period. If a borrower has a balance greater than \$0 for ten consecutive months, the borrower will be unable to request additional cash withdrawals until her balance is \$0 for twenty consecutive days.⁷⁵ Elastic is currently offered in forty states but is not available to borrowers covered under the Military Lending Act because APRs for the product exceed 36%.⁷⁶ For a \$100 loan with three bi-weekly payments, Elastic charges \$10.26 in fees for an APR of 89%.⁷⁷ For a \$100 loan with two monthly payments, Elastic charges \$21.11 in fees for an APR of 128%.⁷⁸

As will be discussed in Part V, there remains a critical role for mainstream financial institutions in solving the payday loan crisis: either deciding to originate small-dollar consumer loans themselves at lower interest rates than payday lenders, or supporting other affordable small-dollar lenders by providing low-interest loan capital. Banks can participate in these ways because it is the right, moral thing to do; because it is a way to cultivate future, mainstream borrowers; and because they can receive CRA credit in return.

2. Credit unions should offer affordable small-dollar loans to their low- and moderate-income members

Credit unions, like banks, should be able to offer small-dollar loans at lower costs than payday lenders and have an opportunity to play a leading role in providing alternatives to payday loans. Like banks, credit unions have several institutional advantages over payday lenders.⁷⁹ Credit unions already have the infrastructure to offer small consumer loans, including physical locations, staff, and an existing customer base that should minimize marketing costs. In addition, credit unions can minimize credit losses through the use of direct deposit and

75. *How It Works*, REPUBLIC BANK, <https://www.elastic.com/how-it-works/> (last visited Nov. 8, 2018); *FAQs*, REPUBLIC BANK, <https://www.elastic.com/FAQs/> (last visited Nov. 8, 2018).

76. *Id.*

77. *What It Costs*, REPUBLIC BANK, <https://www.elastic.com/what-it-costs/> (last visited Nov. 8, 2018).

78. *Id.*

79. Bair, *supra* note 25, at 32.

electronic funds repayments from checking accounts. Finally, credit unions have diverse product offerings and do not have to rely exclusively on the revenues from their small-dollar loan programs, unlike payday lenders. Unlike banks, national credit unions are limited by federal law to 15% interest rates, although the National Credit Union Administration (NCUA) is able to raise that interest rate cap when it deems it necessary; the current permissible interest rate cap for federal credit unions set by the NCUA is 18%, with a 28% interest rate permitted for certain products, as discussed below.⁸⁰

The National Credit Union Foundation estimates that 10% to 20% of credit union members use payday loans.⁸¹ This fact, in addition to all the other press about the need for small-dollar loans, demonstrates that there is a need for members of credit unions to have an affordable small-dollar loan product as an alternative to payday loans. Few credit unions, however, currently offer alternatives to payday loans. Credit unions, like banks, seem to perceive small-dollar loans as not only unprofitable, but also fraught with reputational risk and insufficiently supported by regulators, including the NCUA.⁸² Credit unions may also avoid small-dollar loans because they are perceived as risky products by insurance adjusters and may result in higher insurance premiums on their deposits.⁸³ A credit union also serves a particular community. A credit union might not offer small-dollar loans either because the community it serves has sufficiently high income that there is not a demand for the product or because its board of directors fails to recognize a legitimate demand for the product within the community.⁸⁴

The good news is that some credit unions have made a commitment to providing affordable small-dollar loans to their members and national models are in place for other credit unions to join them. Here are some examples.

80. See Federal Credit Union Act, 12 U.S.C. §1757(5)(A)(vi)(I); see also, NAT'L CREDIT UNION ADMIN., PERMISSIBLE LOAN INTEREST RATE CEILING EXTENDED (2015), <https://www.ncua.gov/Resources/Documents/LFCU2015-02.pdf> (stating that the NCUA was renewing the permissible interest rate of 18% for another three years).

81. NAT'L CREDIT UNION FOUND., PAYDAY LENDING: A REAL SOLUTIONS IMPLEMENTATION GUIDE (Mar. 23, 2009), https://issuu.com/thinkcreative/dosc/real_solutions_payday_loan_toolkit.

82. Bair, *supra* note 25, at 10.

83. Telephone Interview with Aaron Duffy, Appalachian Community Federal Credit Union (Apr. 4, 2018).

84. Telephone Interview with Larry Garcia, *supra* note 32.

a. National Credit Union Administration Payday Alternative Loan (PAL) product: more credit unions should offer this product. The Payday Alternative Loan (PAL) product is a small-dollar loan offered by federal credit unions and regulated by federal law and the NCUA. The NCUA reported that in the fourth quarter of 2017, there were 503 federal credit unions that reported making payday alternative loans and federal credit unions held \$38.6 million in payday alternative loans on their books by the end of the fourth quarter of 2017.⁸⁵

The PAL is available to members of federal credit unions and includes the following required features: principal loan amounts between \$200 and \$1000; a 28% interest rate; a loan application fee of no more than \$20; a repayment term of one month to six months; no rollovers, although the term of the loan may be extended for three months as long as the maximum length of the term is still at or below six months and no fee is charged for the extension; a fully amortized loan; and only one PAL outstanding at a time and no more than three PAL's in any rolling, six-month period.⁸⁶ The NCUA recognized the need for credit unions to charge slightly higher interest rates on the PAL product and increased the permissible interest rate from 18% to 28%.⁸⁷

The federal regulations encourage federal credit unions to develop borrower underwriting standards that strike the appropriate balance between protecting the credit union's financial stability and giving borrowers the quick access to credit that they need. Applicants are required to provide proof of employment or income. The regulations also list optional, helpful loan features, including a savings component, financial education, reporting to credit bureaus, and encouraging borrowers to use payroll deduction for loan repayments.⁸⁸ The NCUA, which also insures credit union deposits, stipulates that a credit union's PAL product will not result in higher insurance premiums so that

85. *NCUA Wants to Expand Payday Lending Alternatives for Credit Unions, Customers*, NAT'L CREDIT UNION ADMIN. (May 24, 2018), <https://www.ncua.gov/newsroom/Pages/news-2018-may-expand-payday-lending-alternatives-credit-unions-consumers.aspx>; 12 C.F.R. § 701 (2010); NAT'L CREDIT UNION ADMIN., 12 CFR PART 701 PAYDAY ALTERNATIVE LOANS PROPOSED RULE, <https://www.ncua.gov/About/Documents/Agenda%20Items/AG20180524Item3b.pdf>.

86. 12 C.F.R. § 701 (2010); Short-Term, Small Amount Loans, 75 Fed. Reg. 58285 (Sept. 24, 2010), <https://www.ncua.gov/Legal/Documents/Regulations/FIR20100916SmAmt.pdf>.

87. See, NAT'L CREDIT UNION ADMIN., FINAL RULE – PART 701, SHORT-TERM, SMALL AMOUNT LOANS (2010), <https://www.ncua.gov/Legal/Documents/Regulatory%20Alerts/RA2010-13.pdf> (reporting the NCUA Board decision to increase the permissible interest rate for PAL loans to 28% APR).

88. *Id.*

credit unions are not penalized with higher premiums for offering a PAL product.⁸⁹

As of 2016, about one in seven federal credit unions participates in the PAL program. These credit unions issued approximately 170,000 loans under the program in 2014, while accounting for far less than 1% of the volume of payday loans issued that year.⁹⁰ There have been promising signs for the PAL program. In 2015, credit unions originated \$123.3 million in payday alternative loans—a 7.2% increase over 2014.⁹¹ During the fourth quarter of 2017, 503 federal credit unions reported making PALs for \$38.6 million in loans total.⁹² On May 24, 2018, the NCUA proposed a rule to create a new product in addition to the PAL.⁹³ In proposing the product, NCUA Board Chairman J. Mark McWatters explained that the PAL product had been “extremely effective” and the NCUA wanted to create additional alternatives to payday loans.⁹⁴ The proposed product includes most of the features of the PAL, with four changes: (1) a maximum loan amount at \$2000 and no minimum loan amount; (2) a maximum term of the loan at twelve months; (3) no required minimum length of credit union membership; and (4) no restrictions on the number of loans a federal credit union may make to the borrower in a six-month period, provided the borrower has only one outstanding loan at a time.⁹⁵

Since the introduction of the PAL program, technology has been developed to aid credit unions in offering PALs. QCash is a technology platform developed by Washington State Employees Credit Union and is available to other credit unions to facilitate the offering of PALs to their members.⁹⁶ QCash allows credit union members to apply for

89. Telephone Interview with Aaron Duffy, *supra* note 83.

90. Nick Bourke, *Why Credit Unions Should Pay Attention to the Payday Loan Market—and What the CFPB Does About It*, PEW CHARITABLE TR. (Jan. 6, 2016), <http://www.pewtrusts.org/en/about/news-room/opinion/2016/01/06/why-credit-unions-should-pay-attention-to-the-payday-loan-market-and-what-the-cfpb-does-about-it>.

91. Eric Naing, *Credit Unions Offering More Payday Alternative Loans*, CQ ROLL CALL (Mar. 21, 2016), Westlaw 2016 CQBNKRPT 0416.

92. *NCUA Wants to Expand Payday Lending Alternatives for Credit Unions, Customers*, *supra* note 85.

93. *Id.*

94. *Id.*

95. *Id.*

96. *About QCash*, QCASH FIN., <https://www.q-cash.com/about-qcash/> (last visited Nov. 8, 2018); Telephone Interview with Jim Brown, University Federal Credit Union, (May 11, 2018).

PALs either online or through a mobile app.⁹⁷ QCash has customizable features that enable QCash to remain compliant with regulations regardless of the state in which the loan is issued.⁹⁸ The credit union can also set their own pricing, terms, and underwriting criteria for the PAL to meet the particular needs of the credit union.⁹⁹

The NCUA PAL program demonstrates that credit unions can offer viable alternatives to payday loans and represents a public policy blessing from the NCUA in support of credit unions offering affordable small-dollar loans. The NCUA could further encourage the development of small-dollar loan programs by instituting a grant or subsidy program. Small dollar loan programs are sometimes offered at a loss to the credit union initially before the credit union can drive down costs and refer customers to higher-margin products. A grant or subsidy program could off-set the initial loss and encourage more credit unions to develop small-dollar loan products.

b. Employer sponsored small-dollar loans: a partnership between credit unions and employers. The Employer Sponsored Small-Dollar Loan Program is an employer-based, small-dollar loan product that was successfully tested by the Filene Research Institute to help credit unions provide affordable, financially sustainable products and services for their low- and moderate-income members.¹⁰⁰ The program acts as a partnership between employers and credit unions. Specifically, employees are offered small-dollar loans of up to \$2000, with terms of ninety days to one year and interest rates in the 15.99% to 17.99% range, which enables the product to be both affordable to the borrower and self-sustaining for the lender.¹⁰¹ The loans are underwritten based on the ability of the borrower to repay the loan, not on a credit score, and credit reports are pulled for informational purposes only.¹⁰² Employees are required to be a member of the credit union and to have worked for the employer for six to twelve months, depending on the agreement between the employer and the credit union.¹⁰³ Employees repay the loan via payroll deduction on

97. FAQs, QCASH FIN., <https://www.q-cash.com/faqs/> (last visited Nov. 8, 2018); Telephone Interview with Jim Brown, *supra* note 96.

98. *About QCash*, *supra* note 96.

99. *Id.*; Telephone Interview with Jim Brown, *supra* note 96.

100. *Feasibility Study Report Employer-Sponsored Small-Dollar Loan*, 1 FILENE RES. INST. 24 (2017), <https://filene.org/do-something/programs/employer-sponsored-small-dollar-loans>.

101. *Id.* at 5.

102. *Id.*

103. *Id.*

payday and are only able to take out one loan at a time.¹⁰⁴ After the loan has been repaid, the automatic payroll deduction is continued by the employer, unless the employee opts out, and money that was previously used to repay the loan is put into a savings account for the employee.¹⁰⁵ Successful repayment of a loan is reported to the credit bureaus to establish or improve the borrower's credit.¹⁰⁶ Employers are required to pay a small sponsorship fee, based on the number of employees, which helps offset losses to the credit union from the program.¹⁰⁷

c. Examples of good credit union small-dollar loan programs. The North Carolina State Employees' Credit Union, which is the second largest credit union in the country, offers its members a small-dollar loan in the form of a Salary Advance Loan. The North Carolina State Employees' Credit Union serves North Carolina state and public-school employees and their families. To be eligible for the loan, members are required to have already set up direct deposit from their paycheck into their depository account. The loan can be up to \$500 with an APR of 12%. The credit union added a forced savings component to the terms that requires 5% of each loan to be put into a savings account. The product is very profitable, with charge-offs of only 0.24%.¹⁰⁸ Five years after the product's inception in 2001, the product became the credit union's most profitable product and the mandatory savings requirement generated \$10 million in new deposit funds.¹⁰⁹

NorthCountry Federal Credit Union in Burlington, Vermont provides an employer-based small-dollar loan in amounts up to \$1000 to employees who have worked for the employer for at least one year, with an APR in the 15% to 18% range, and no credit check. NorthCountry's director of credit administration, Jeff Smith, was recently quoted in the Wall Street Journal saying "Part of what credit unions are founded to do is to provide small-dollar loans to people of limited means . . . We are breaking even with this program. It certainly achieves part of what we are founded to do."¹¹⁰ To offer the product,

104. *Id.*

105. *Id.*

106. *Id.*

107. *Id.*

108. Kenneth, *supra* note 4, at 697.

109. Kelly J. Noyes, Comment, *Get Cash Until Payday! The Payday-Loan Problem in Wisconsin*, 2006 WIS. L. REV. 1627, 1677 (2006).

110. Yuka Hayashi, *New Workplace Perk: Loans for Low-Income Employees*, WALL ST. J. (Nov. 2, 2017, 5:30 AM), <https://www.wsj.com/articles/new-workplace-perk-loans-for-low-income-employees-1509615001> (quoting Jeff Smith with North Country Federal Credit Union in

NorthCountry works with over thirty employers in Vermont with a combined 4700 employees.¹¹¹

The ASI Federal Credit Union in Louisiana offers the “Stretch Plan” “which offers a line of credit at 12% with a maximum amount of \$500, or \$1000 after the individual has successfully used the program for a period of time, and a \$4 per week fee for membership in the plan.”¹¹² The borrower must pay back the loan in two equal installments starting on the second payday after the loan. This repayment term is designed to give the borrower more time to recover from the emergency that required immediate cash than the two weeks of the traditional payday loan. “The credit union made 8000 such loans in 2004, with a charge-off rate of only 0.35% to 0.37%, and almost one-third of the credit union’s operating income is from the program.”¹¹³

A credit union’s senior management and board of directors are instrumental in the decision to launch small-dollar loan programs.¹¹⁴ They must first identify a need for small-dollar loan products in the community they serve and then dedicate the credit union’s resources to launching and sustaining the product. Credit unions are governed by member-elected boards of directors.¹¹⁵ Credit-union members and consumer advocates can influence a credit union’s policy toward support for small-dollar loan products by electing onto the board candidates who recognize the need within the membership for these products and are willing to devote resources to develop them.¹¹⁶

B. The Non-Profit Sector and Affordable Small-Dollar Loans

The non-profit sector is an important part of the small-dollar loans solution to payday loans both because there is no pressure from shareholders to return large profits and because non-profit organizations have deep connections to payday loan borrowers. Non-profit social service agencies are already on the front lines of helping low-income families—whether providing those families with affordable housing or

Burlington, Vermont).

111. *Id.*

112. Kenneth, *supra* note 4, at 697.

113. *Id.*

114. Telephone Interview with Larry Garcia, *supra* note 32.

115. Wendy Cassity, Note, *The Case for A Credit Union Community Reinvestment Act*, 100 COLUM. L. REV. 331, 355 n.152 (2000).

116. *See also*, Scheiber, *supra* note 9 (describing need to get low-paid workers as well as high-paid senior directors elected to the board of credit unions).

job training or small business coaching, to name just a few programs. The staff of non-profit organizations interact with their low-income clients frequently and understand the numerous challenges that they face. They also see and understand the financial harms done by payday lending. Perhaps most importantly, they have already earned the trust of their clients. The work of the non-profit sector is made harder by the financial burdens that payday loans create,¹¹⁷ which is what has driven some non-profit lenders to offer an alternative, affordable source of small-dollar credit to their clients. However, while non-profit lenders are more likely than other lenders to have existing, healthy relationships with low- and moderate-income borrowers, they have a harder time accessing capital. Specifically, non-profit lenders must devote staff time to apply for grant money and low-interest loans from banks and foundations to fund loan capital, legal fees, regulatory-compliance filing fees, and marketing expenses. Non-profit lenders, like for-profit fintech lenders, have more regulatory burdens than financial institutions because they must comply with the different lending requirements in each state where they make loans. In contrast, federal credit unions must comply with only one set of regulations from the National Credit Union Administration, and federal banks have the right under the National Banking Act to choose one state's lending laws to cover their lending activities in all fifty states. In addition, despite their non-profit status, non-profit lenders must pay the same high market rates for marketing and for reporting their borrowers' good credit to the three credit bureaus.

1. The Community Loan Center Affordable Small Dollar Loans Program

The Community Loan Center Affordable Small Dollar Loans Program (“the CLC Program”) is an example of a financially self-sustaining, online, employer-based, small-dollar loan product offered by a network of non-profit lenders which makes a difference in the lives of many low- and moderate-income consumers. As of November 2018, the CLC Program has loaned out almost \$32 million in small-dollar loans.¹¹⁸

117. See, e.g., Ann Baddour et al., *Reshaping the Future of Small Dollar Lending in Texas: Alternatives to High-Cost Payday and Auto Title Loans*, 1 TEX. APPLESEED 91, 21-23 (2012), <https://www.texasappleseed.org/sites/default/files/15-PDL-Alternatives.pdf>.

118. Email to Eliza Platts-Mills from Howard Porter, Program Manager, Community

The CLC Program was started after social justice consumer advocates in Texas found that state-level legislative-reform efforts and borrower education were ineffective in countering the harm done to working-class families by payday loans. Nick Mitchell-Bennett is the entrepreneurial Executive Director of the Community Development Corporation of Brownsville, a non-profit affordable-housing developer in Texas's Rio Grande Valley, one of the poorest areas of the country.¹¹⁹ In 2010, Mr. Mitchell-Bennett and his colleagues in Brownsville were frustrated to see the low-income families that they were working with getting poorer despite the end of the recession.¹²⁰ They realized that a big part of the problem was payday loans.¹²¹ Mr. Mitchell-Bennett was on the verge of accepting a \$25,000 grant from the Federal Home Loan Mortgage Corporation, known as Freddie Mac, to launch a financial education marketing campaign called "Don't Borrow Trouble" when someone asked him what families were supposed to do instead of taking out payday loans.¹²² Mr. Mitchell-Bennett gave back the grant and launched the CLC Program, with financial support from the Rio Grande Valley Multibank Corporation, a CDFI founded in 1995 by local investor stockholder banks; strategic support from consumer advocates across Texas including Ann Badour of Texas Appleseed, Woody Widrow of RAISE Texas, and Matt Hull of Texas Community Capital; and software support from a good friend. Along the way, the CLC Program has benefited from pro-bono legal support from the University of Texas School of Law's Entrepreneurship and Community Development Clinic and strategic planning support from an Advisory Committee comprised of funders, consumer advocates, and lenders across Texas, including the Federal Reserve Bank of Dallas. Mr. Mitchell-Bennett also credits his extensive national network of non-profit-based social-justice advocates for the success of the CLC Program.¹²³

Loan Center Affordable Small Dollar Loans Program, Texas Community Capital (Nov. 14, 2018).

119. Elizabeth Duffrin, *Thwarting Payday Lenders at the Texas Border*, NACEDA (Apr. 27, 2015), http://www.naceda.org/index.php?option=com_dailyplanetblog%26view%3Dentry%26category%3Dpeople-places%26id%3D6:thwarting-payday-lenders-at-the-texas-border.

120. *Id.*

121. *Id.*

122. *Id.*

123. Telephone Interview with Nick Mitchell-Bennett, Community Loan Center of the Rio Grande Valley (May 22, 2018).

The CLC Program is an employer-based, online small-dollar loan program that operates through a network of non-profit local lenders and offers loans of up to \$1000, repayable over a one-year term, at 18% interest, with a \$20 administrative fee. The \$20 administrative fee is financed into the loan for an APR of 21.73%. Borrowers may borrow up to \$1000, capped at 50% of their take home monthly pay. Borrowers are permitted to take out a subsequent loan only after they have paid back at least 50% of the original loan balance of their prior loan. Borrowers primarily repay the loan using either payroll deduction set up through their employer or an automatic electronic funds transfer from their bank account. The CLC Program is offered to employees of participating employers as a voluntary benefit of their employment, and all aspects of the loan program, from application to funding and repayment by the borrower, are done online using custom-built, cloud-based loan origination and servicing software. CLC lenders are required to offer free financial counseling to their borrowers, but borrowers are not required to participate in financial counseling in order to receive a CLC loan.

The employers participating in the CLC Program do not have any financial responsibility for the loan. Their primary administrative responsibilities are limited to confirming that the borrower is an employee, and setting up payroll deduction when selected by the borrower as the method of repayment. Employer-sponsored loan programs are offered to employees as a voluntary benefit. These programs keep costs down in two main ways: First, instead of incurring time and labor costs underwriting each borrower, the lender decides which employers to approach and essentially underwrites the employer. Second, while borrowers must be given the option to repay the loan by payroll deduction, electronic funds transfer, check, or cash, most borrowers choose payroll deduction, which helps to lower default rates.¹²⁴ Employer-sponsored loan programs typically only register defaults from borrowers when the employee borrower leaves that employer.¹²⁵

124. See Electronic Funds Transfer Act, Regulation E 12 C.F.R. § 205.10(e) (2017) (prohibiting financial institutions or other lenders from conditioning receipt of a loan on repayment by preauthorized electronic funds transfers, except for credit extended under an overdraft credit plan).

125. Hayashi, *supra* note 110.

The CLC Program is a good example of a financially self-sustaining small-dollar loan product with far less expensive terms than a payday loan product. As of November 2018, the CLC Program had originated over 42,000 loans, totaling almost \$32 million, with a charge-off rate from January 2017 to November 2018 of 4.85%.¹²⁶ When compared with average payday loan fees in Texas amounting to 500% APR, the CLC Program is estimated to have saved Texas borrowers almost \$23 million. While the CLC Program does not collect household income data from borrowers at the time that they apply for the loan, a third-party non-profit organization conducted a voluntary, three-part online survey of CLC borrowers to collect demographic and other data.¹²⁷ The data shows that the average CLC borrower resembles the typical payday loan borrower.¹²⁸

The local lenders participating in the CLC Program are non-profit, community-based organizations that have added the small-dollar loan program to their affordable housing or small business support programs. Local lenders in the program are encouraged to raise \$500,000 in start-up loan capital and administrative funds before they start lending, and the expectation is that the program will be financially self-sustaining for the local lenders within two years. The local lenders raise their operating and lending capital from banks and foundations, including through partnerships with local chapters of United Way and Goodwill. In addition, the CLC of the Rio Grande Valley and the CLC network coordinator, Texas Community Capital, have been successful obtaining grants and low-interest loan capital from national foundations that they then make available to local lenders. Financial support has also come from the Citi Bank Foundation, Wells Fargo, the Opportunity Finance Network, the John D. and Catherine T. MacArthur Foundation, Prudential Financial, The Kresge Foundation, the Kellogg Foundation, BBVA Compass, Mercy Partnership Fund, and Dignity Health Fund, among others.

The CLC Program originated in Texas, a state that has done little to regulate payday lenders, that is home to some of the biggest and

126. Emails to Eliza Platts-Mills from Howard Porter, Program Manager, Community Loan Center Affordable Small Dollar Loans Program, Texas Community Capital, (Nov. 14 and 16, 2018).

127. Yamanda Wright & Ann Baddour, *Assessing Impacts of the Community Loan Center Affordable Small Dollar Loan Program on the Financial Well-Being of Borrowers*, 1 TEXAS APPLESEED 34 (2017), <https://www.texasappleseed.org/sites/default/files/Fair%20Loans%20and%20Family%20Finances.pdf>.

128. *Id.* at 2-3.

most profitable payday loan corporations, and that has average payday loan APRs of 500% and higher. To date, the CLC Program has local lenders in eight metropolitan areas across Texas and also in Indiana, Maryland, Missouri, North Carolina, South Carolina, Tennessee, Alabama, and Arizona. As discussed in Part V below, banks and foundations should receive Community Reinvestment Act credit in exchange for extending affordable loan capital to local lenders in the CLC Program, or banks could choose to become local lenders in the CLC program themselves and help bring the program to scale through their own, direct lending.

C. The Fintech Sector and Affordable Small-Dollar Loans

It has become common to read about technology entrepreneurs in Silicon Valley creating start-ups to tackle some of the country's most intractable social problems, including income inequality and the need for small-dollar credit. Some of these high-tech financial service start-ups, referred to as the "fintech sector," are engaged in small-dollar lending directly to consumers, hoping to take market share away from payday lenders. Others are using technology and big data to create alternative credit risk analysis to traditional credit reports, with the goal of obtaining a more detailed and accurate picture of a prospective borrower's ability to repay a loan. Yet another group of entrepreneurs uses search engine optimization tools to help borrowers counteract the huge, online presence of payday lenders. A fourth category of for-profit companies engaged with alleviating the financial pressures facing low- and moderate-income households focuses on smoothing out the peaks and valleys of a person's income, hoping to minimize the need for small-dollar credit altogether.

Many big banks are providing financial support to the fintech sector. JP Morgan Chase's philanthropic foundation has partnered with the non-profit Center for Financial Services Innovation to fund start-ups through the Financial Solutions Lab, which holds an annual competition to support innovative start-ups seeking to improve the financial health of low-income consumers. While the for-profit fintech sector has an easier time accessing start-up and loan capital than the non-profit sector, the for-profit fintech sector must work hard to build trust with small-dollar borrowers and must have government checks in place, through federal and state regulators, to ensure that it keeps its promises to consumers.

1. Fig Loans: offering transparent, consumer-friendly loans to help borrowers rebuild their credit and their financial health

Fig Loans is a good example of a relatively new fintech company that is building a financially sustainable model for providing small-dollar loans to low- and moderate-income consumers. Fig Loans was founded in 2015 by two Wharton business school graduates with the primary goal of helping low- and moderate-income families improve their financial health.¹²⁹ The two founders, Jeff Zhou and John Li, soon understood that before low- and moderate-income families can improve their credit histories and their financial health, those families need access to small-dollar loans less expensive than payday loans. To learn more about the problems with payday loans and to build trust with borrowers, Zhou and Li cold called non-profit organizations across the country to learn how their clients interacted with payday loans.¹³⁰ United Way of Greater Houston was the most responsive non-profit. The interest from the United Way of Greater Houston, in addition to the prominent payday loan industry in Texas, led Fig Loans to start its lending in Houston. United Way of Greater Houston runs a collaborative named United Way THRIVE, in which nonprofit partners, employers, financial institutions, local and state government agencies, and community colleges help low-income families achieve strong financial health through better skills and education, jobs, and financial habits.¹³¹

In October 2015, Fig Loans launched its Fig Loan product, which offers borrowers loans of \$300 to \$750 repayable over four to six months in installment payments that include principal and all fees and interest. The highest total fees and interest charged by Fig Loans for a Fig Loan amounts to an APR of 190%, which was chosen to cover costs.¹³² Co-founder Zhou is quick to stress that a loan should be evaluated on more than its APR alone, pointing to these additional features of the Fig Loan product: Fig Loan extends its loan repayment due

129. Taylor Soper, *Startup Spotlight: Fig Loans Offers Alternative to Payday Loans with More Long-term Benefits*, GEEKWIRE (Apr. 28, 2016, 4:43 PM), <https://www.geekwire.com/2016/fig-loans/>.

130. *Why Fig Loan Started in Houston*, FIG LOANS, <https://www.figloans.com/about/fig-texas-story> (last visited Nov. 8, 2018).

131. *United Way THRIVE*, UNITED WAY OF GREATER HOUS. (2018), <https://www.unit-edwayhouston.org/our-work/family-stability/united-way-thrive>.

132. FIG LOANS, <https://www.figloans.com/> (last visited Nov. 8, 2018).

dates without assessing any fees, reports to credit agencies to help families build good credit, gives financial education to borrowers during the relationship, and refuses to charge any other fees beyond the transparent 190% flat fee.¹³³

Fig Loans attracts private investors with the potential of monetizing the proprietary underwriting algorithm that the company is developing.¹³⁴ Rather than relying on traditional FICO credit scores or doing labor-intensive, manual review of each applicant's records, Fig Loans is developing an algorithm that looks at a digital copy of an applicant's bank statements to determine whether an applicant can afford to pay back the loan and whether an applicant is likely to commit fraud. Zhou describes it as cash flow underwriting and claims that it will result in a more nuanced picture of the financial health of households whose FICO score falls below the industry standard of 600.¹³⁵

When asked about the appropriateness of a 190% flat fee, Zhou explains that the company started at 80% but realized they could not be profitable at that rate.¹³⁶ He adds that the company would like to lend at 36% and that it hopes to bring down its interest rate after increasing its loan volume and fully deploying its bank statement underwriting algorithm.¹³⁷ Zhou describes his top two expenses as bad debt and marketing expenses. With regard to bad debt, which he describes as the percentage of borrowers with no intention of repaying their loan, he hopes that his algorithm will enable the company to detect those borrowers ahead of time. With regard to marketing, he says the challenge is that marketing companies, like radio stations, Google, or newspapers, sell their space to the highest bidder, and traditional payday lenders can outbid companies like Fig Loans and dominate these marketing outlets.¹³⁸ Zhou hopes to be able to defray costs as the company grows and originates more loans. He is not surprised that relatively few lenders have entered the market for small-dollar loans, both because of the negative stigma attached to the industry by payday lenders and the high ongoing costs.¹³⁹

133. Telephone Interview with Jeff Zhou, Co-Founder, Fig Loans (Apr. 10, 2018).

134. *Id.*

135. *Id.*

136. *Id.*

137. *Id.*

138. *Id.*

139. *Id.*

The founders of Fig Loans entered the small-dollar loan market with the goal of helping consumers improve their credit and their overall financial well-being.¹⁴⁰ Fig Loans tries to differentiate itself from payday lenders in at least four ways. First, Fig Loan points out that its 190% flat fee is 60-70% less than the 400-500% APR typical in Texas.¹⁴¹ Second, the company administers its Fig Loan product in a transparent, consumer friendly way, including extending loan repayment deadlines for borrowers when needed without assessing any additional fees or additional interest. As a result, for borrowers for whom the loan repayment deadline is extended, with no additional fees or interest, the actual, effective APR on their Fig Loan is lower than 190%.¹⁴² Third, unlike most payday lenders, Fig Loans incurs the cost of submitting reports to the three major credit bureaus so that borrowers who repay their Fig Loan on time will start to build good credit. Fourth, Fig Loans has partnered with non-profit organizations, primarily the United Way of Greater Houston and Family Services of Greater Houston, with deep ties to low- and moderate-income borrowers.

Consumer advocates and regulators should look to for-profit lenders like Fig Loans when trying to decide how to define best practices for small-dollar loans and which regulations to endorse. A regulation that caps all small-dollar loans at 36% would prevent a fintech like Fig Loans from entering the market. A higher interest rate, while still safely below the 400-500% APRs of payday lenders, would allow for more competition and more choice for consumers.

2. LendUp: a cautionary tale of the need for federal oversight

LendUp, based in San Francisco, is a well-funded fintech small-dollar lender that has drawn the attention of both venture-capital firms and regulators. Founded in 2012, the company offers online small-dollar consumer loans to borrowers with low credit scores and has recently started offering credit cards to those same borrowers, although it is likely to spin that business off.¹⁴³ LendUp has received \$325 mil-

140. *Philosophy*, FIG LOANS, <https://figloans.com/about/responsible-lending-model> (last visited Nov. 8, 2018).

141. FIG LOANS, *supra*, note 132.

142. *Id.*

143. Mark Calvey, *LendUp to Spilt in Two as Fin Tech Decides It Is Worth More in*

lion in equity and debt financing from PayPal, Kleiner Perkins Caufield & Byers, Google Ventures, Andreessen Horowitz, and others.¹⁴⁴ The company offers borrowers online, single-payment loans of \$100 to \$500, repayable in up to thirty days, and online installment loans of \$100 to \$1000, repayable over a longer term.¹⁴⁵ A borrower's exact loan terms vary by state and by a borrower's credit history, which LendUp determines using traditional credit scores and a prospective borrower's non-traditional credit history.¹⁴⁶ LendUp's business model includes a "LendUp Ladder" which enables borrowers in some states to access longer-term loans at rates under 36% APR, if they repay their first loans on time and take LendUp's free education courses.¹⁴⁷ For some of its loans, LendUp reports on-time repayments to credit bureaus to help borrowers establish or improve their credit.¹⁴⁸

A sample, single-payment loan on LendUp's website shows \$200 borrowed, repayable in one payment in two-week's time, with total interest amounting to \$35.20, or 458.86% APR.¹⁴⁹ While the triple digit APRs on LendUp's initial loans to borrowers are similar to the high interest rate and fees that borrowers are charged on payday loans, there are two key differences between LendUp and payday lenders. First, LendUp does not allow any rollovers, so its borrowers would never owe more than the interest included in the initial loan.¹⁵⁰ Second, most LendUp borrowers who are able to repay their initial loan on time and complete a financial education course are able to move up the LendUp Ladder and earn access to longer-term, lower-interest loans.¹⁵¹ However, the initial interest rates on LendUp loans are very high.

Pieces, S.F. BUS. TIMES (Oct. 19, 2018), <https://www.bizjournals.com/sanfrancisco/news/2018/10/19/lendup-split-fintech-credit-cards-subprime-loans.html> (citing an anonymous source that says that offering a credit card requires working with a bank and banks do not want to partner with a company that is offering loans with payday-level interest rates).

144. See *LendUp*, WIKIPEDIA, <https://en.wikipedia.org/wiki/LendUp> (last visited Nov. 17, 2018).

145. LENDUP, <https://www.lendup.com/> (last visited Nov. 9, 2018).

146. *Our Take on the Payday Loan Industry*, LENDUP, <https://www.lendup.com/en/our-take-on-payday> (last visited Nov. 17, 2018).

147. *Here's how the LendUp Ladder works in California*, LENDUP, <https://www.lendup.com/ladder> (last visited Nov. 24, 2018); Amrita Jayakumar, *LendUp Loan 2018 Review*, NERDWALLET (June 22, 2018), <https://www.nerdwallet.com/blog/loans/lendup-loan-review/>.

148. Jayakumar, *supra* note 147.

149. LENDUP, *supra* note 145.

150. *Our Take on the Payday Loan Industry*, *supra* note 146.

151. See Jayakumar, *supra* note 147.

In 2016, LendUp made the news as the subject of an enforcement action by the federal Consumer Financial Protection Bureau (CFPB), which found that the company was failing consumers on three fronts: (1) it was not decreasing the interest rate for some borrowers who repaid on time, despite promising to do so, (2) it had not been reporting all repayments to the credit bureaus, despite promising to do so, and (3) it had failed to clearly disclose some of its fees to borrowers.¹⁵² It is critical that federal and state enforcement agencies remain vigilant on behalf of consumers to ensure that lenders claiming to be providing a better small-dollar loan product to borrowers are in fact doing so.

3. Progreso Financiero/Oportun: an innovator and early leader in the affordable small-dollar loans market

Oportun, previously known as Progreso Financiero, was an early leader and innovator in the affordable small-dollar loan market. The company is a mission-driven, for-profit CDFI that offers unsecured installment loans between \$300 and \$6000, with loan terms ranging from seven months to forty-two months, with payments due twice a month.¹⁵³ Oportun uses its own credit-scoring system to determine a borrower's credit history and interest rate, and reports loan repayments to two major credit bureaus to help borrowers establish a traditional credit history.¹⁵⁴ In January of 2017, the Center for Financial Services Innovation published the results of a study commissioned by Oportun measuring how much its borrowers were saving with an Oportun loan compared to a payday loan.¹⁵⁵ The results indicate that, for the 814,471 borrowers who first took out an Oportun loan between

152. *See CFPB Orders LendUp to Pay \$3.63 Million for Failing to Deliver Promised Benefits*, CONSUMER FIN. PROT. BUREAU (Sept. 27, 2016), <https://www.consumerfinance.gov/about-us/newsroom/lendup-enforcement-action/>; *see also* Amrita Jayakumar, *Payday Alternative LendUp Owes \$6.3 Million for Misleading Borrowers*, NERDWALLET (Sept. 27, 2016), <https://www.nerdwallet.com/blog/loans/lendup-settlement/> (describing refunds and penalties assessed by the CFPB and by the California state regulator).

153. OPORTUN, <https://www.oportun.com/en/> (last visited Nov. 8, 2018).

154. *See Our Story*, OPORTUN, <https://www.oportun.com/en/about/story/> (last visited Nov. 8, 2018).

155. *Oportun: The Trust Cost of a Loan*, 1 CTR. FOR FIN. SERVS. INNOVATION 17 (Jan. 2017), https://www.oportun.com/studies/201701_CFSI_Oportun_Total_Cost_of_Loan_White_paper.pdf.

October 2008 and December 2016 and who had annual household incomes of up to \$50,000, the average borrower saved \$1130 on her first loan, and collectively, Oportun borrowers saved \$921 million.¹⁵⁶

Progreso Financiero originated its first loan in 2005 and started by providing small, unsecured loans to unbanked and underbanked Hispanics in Texas and California, whom it reached by setting up kiosks in grocery stores popular with Hispanic consumers. The company's mission is to help Hispanic borrowers build credit histories so that they can access mainstream financial services.¹⁵⁷ Since its first loan in 2005, the company has extended \$5.4 billion dollars of credit to over 1.2 million low- and moderate-income Hispanic borrowers in Arizona, California, Florida, Idaho, Illinois, Missouri, New Jersey, New Mexico, Nevada, Texas, Utah, and Wisconsin.¹⁵⁸

Oportun continues to create innovative, important financial services products. In 2018, the company announced a product to counteract the harm to consumers from banks' overdraft fee charges: for customers who link a bank account to Oportun, the company will send the customer a text alert when the account drops below \$100 and will offer a \$100 cash advance repayable at no cost, unlike the deposit advances and overdraft fees at banks. The cash advance is paid back with zero interest when the customer replenishes her bank account.¹⁵⁹

4. NerdWallet: guiding borrowers to the best loan options

NerdWallet is a start-up based in California that is not offering financial products to consumers, but is instead providing consumers with objective, comparative information about a wide range of financial products including credit cards, insurance, mortgage loans, and personal and business loans.¹⁶⁰ NerdWallet currently offers its online search services for free to steer borrowers looking for loans online

156. *Id.*

157. Luz Gomez, *Progreso Financiero: A Case Study of Business Model Innovation*, 1 CDFI 6 (Jan. 2013), [https://www.cdfifund.gov/Documents/\(6\)%20Progreso%20Financiero%20-%20A%20Case%20Study%20of%20Business%20Model%20Innovation.pdf](https://www.cdfifund.gov/Documents/(6)%20Progreso%20Financiero%20-%20A%20Case%20Study%20of%20Business%20Model%20Innovation.pdf).

158. *Our Story*, *supra* note 154.

159. Kevin Wack, *A \$100 Cash Advance for Free? One Firm is Trying the Idea*, AM. BANKER (Apr. 12, 2018, 6:05 AM), <https://www.americanbanker.com/news/a-100-cash-advance-for-free-one-firm-is-trying-the-idea>.

160. Ron Lieber, *A Private Equity Alum's Guide to Better Payday Lenders*, N.Y. TIMES (Apr. 29, 2016), <https://www.nytimes.com/2016/04/30/your-money/at-nerdwallet-guide-to-better-payday-lenders-james-zhang.html>; *NerdWallet*, WIKIPEDIA, <https://en.wikipedia.org/wiki/NerdWallet> (last visited Nov. 8, 2018).

away from high-cost payday loans and towards more affordable lenders. NerdWallet's website includes easy-to-read articles about personal loans and includes a search engine that provides borrowers with a list of personal loan products in their geographic area and a description of the main features of those loans and the application process. The company carefully vets and researches lenders before including them on its website. NerdWallet also has a staff of financial experts who can be reached on the phone to answer questions and give tailored advice, and whose articles and opinions are carried by the national media.¹⁶¹ To date, the website only features personal loans of \$1000 and higher. These small-dollar loans all feature APRs below 36%, loan terms of one to five years, quick processing time on loan applications, and some flexibility with underwriting—although most of the lenders require a minimum FICO score of 600.

NerdWallet has also done advocacy work in New Jersey to shine light on state pension funds and university endowments that are investing in the payday loan industry through private equity.¹⁶²

5. PayActiv, Flex Wage, and Activehours: helping borrowers access their income before payday

Some fintech entrepreneurs are hoping to preempt the need for payday loans or small-dollar loans by enabling borrowers to access their monthly income when they need it, for a fee. These entrepreneurs focus on the fact that the majority of payday loan borrowers turn to payday loans because they must pay their rent and their utilities towards the beginning of the month but do not get paid until the middle or the end of the month. Some employees already have the option to get paid daily because of the sector of the economy that they work in, including those who earn tips and those in the new gig economy, like drivers for Lyft and Uber. Some employees for larger, more traditional employers now also have the option to take home wages when they are earned rather than waiting for payday, thanks to these new fintech companies.

161. See, e.g., Amrita Jayakumar, *Payday Loan Alternative LendUp to Pay \$6.3 Million for Misleading Customers*, CHRISTIAN SC. MONITOR (Sept. 30, 2016), <https://www.csmonitor.com/Business/Saving-Money/2016/0930/Payday-loan-alternative-LendUp-to-pay-6.3-million-for-misleading-customers> (describing the CFPB's settlement with LendUp and encouraging borrowers to look for cheaper forms of credit).

162. Lieber, *supra* note 160.

PayActiv, based in San Jose, California, and Flex Wage, based in Mountainside, New Jersey, are examples of technology start-ups which enable participating employers to offer their employees real-time access to their earned but unpaid wages through an ATM at their workplace.¹⁶³ The start-ups charge employees \$3 to \$5 per transaction, and some employers, including Goodwill, cover some of that cost for their employees. PayActiv uses its own cash to fund the employee withdrawals and then recovers that money back from the employer on payday. Flex Wage moves the cash advance directly from the employer to the employee and has recently partnered with ADP, a large payroll services company, hoping to attract more employers to participate. Other start-ups, including Palo Alto-based Activehours, market their technology directly to employees, giving them the opportunity to withdraw their wages before payday in exchange for giving Activehours access to their checking account on payday. Instead of charging a set fee per transaction, Activehours allows employees to pay how much they think the service is worth to them.

While the much better solution would be for employers to pay a living wage and give employees sufficient hours, a short-term fix may be to enable employees to access their wages as they are earned rather than at the end of a pay period.

D. The U.S. Postal Service and Affordable Small-Dollar Loans

One potentially significant small-dollar loan proposal is for the United States Postal Service, with its extensive network of brick and mortar locations and its large number of postal customers, to offer affordable small-dollar loans, in addition to low-cost checking and savings accounts. The U.S. Postal Service already has the physical infrastructure in place to reach a large number of customers and is a familiar, trustworthy presence in every community. The idea of a public small-dollar loan program has been endorsed by Elizabeth Warren, Bernie Sanders, and other consumer advocates.¹⁶⁴ The Postal Banking Act was introduced on April 25, 2018 by Senator Kirsten Gillibrand

163. Stacy Cowley, *New Payday Options for Making Ends Meet*, N.Y. TIMES (July 4, 2016), <https://www.nytimes.com/2016/07/05/business/dealbook/new-payday-options-for-making-endsmeet.html>.

164. Daniel Marans, *Kirsten Gillibrand Unveils a Public Option for Banking*, HUFFINGTON POST (Apr. 25, 2018), https://www.huffingtonpost.com/entry/kirstengillibrand-postal-banking-bill_us_5ae07f9fe4b07be4d4c6feae?ncid=engmodushpimg00000004.

and includes both low-cost checking and savings accounts and also low-interest small-dollar loans.¹⁶⁵ The bill provides for small-dollar loans of up to \$500, with individuals limited to borrowing a total of \$1000 over one year, and with an interest rate slightly higher than the yield on one-month Treasury bonds, which is currently around 1.65%. The Postal Service's Inspector General report from 2014 suggested it would need interest rates closer to 28% to account for loan defaults and suggested limiting loan amounts to 50% of a borrower's gross paycheck.¹⁶⁶ Other countries' postal services successfully provide financial services to customers.¹⁶⁷

Postal banking is not new to the United States. From 1911 to 1967, the United States Postal Savings Service (USPSS) operated savings accounts across the country with an interest rate capped at 2.25-2.5%, to keep the postal banks from taking customers away from private banks.¹⁶⁸ At its peak in 1947, the system of postal banks in the United States had \$3.4 billion in deposits and four million users at post offices across the country.¹⁶⁹ In addition to offering consumers a much more affordable alternative to payday loans, reinstating postal banking could also provide a steady and needed source of income for the postal service, an independent federal agency that relies on the sale of services to cover its expenses.¹⁷⁰ The Postal Service's Inspector General's Office estimates that the Service could earn as much as \$8.9 billion a year if it entered the small-dollar, short-term loan business.¹⁷¹

As Professor Mehrsa Baradaran writes, the postal savings account system in the United States was terminated when banks, which could offer higher interest rates, had branches within easy reach of most Americans:

In 1946, 68 percent of the nation's towns and cities had both postal savings depositories and banks. And because banks could charge higher interest than the post office and were just as safe, the USPSS was no longer an attractive option for deposits. This is no longer true today as banks have been squeezed on all sides by money markets,

165. Postal Banking Act, S. 2755, 115th Cong. (2018).

166. Office of Inspector Gen., U.S. Postal Serv., *Providing Non-Bank Financial Services for the Underserved* 13 (2014).

167. *Id.* at 25, app. C.

168. *Id.* at 8, 22, app. A.

169. *Id.* at 8, 23, app. A.

170. *Id.* at 16.

171. *Id.*

capital markets, and foreign banks. Banks began to abandon poor areas and post offices remained, but without banking services. And once banks deserted low-income neighborhoods starting in the 1970s, the high-cost payday lenders and check-cashers flooded in.¹⁷²

Reinstating postal checking and savings accounts and introducing postal, low-interest small-dollar loans could make much needed financial services available to all Americans at a much more affordable price.

V. AFFORDABLE SMALL-DOLLAR LOAN PROGRAMS NEED FINANCIAL AND REGULATORY SUPPORT AND SUPPORT FROM CONSUMER ADVOCATES

The affordable small-dollar loan programs described in Part IV need support from federal regulators, the financial sector, and consumer advocates. Part V describes the specific support that is needed. First, the federal regulators of banks and credit unions should continue their recent support for these institutions offering small-dollar loans at rates far below those of payday lenders. Second, the CRA should be interpreted to penalize banks participating in and supporting the payday loan industry and endorse banks participating in and supporting affordable small-dollar loan programs. Third, banks and foundations must continue to provide financial support to small-dollar loan programs offered by CDFI and non-profit lenders. Fourth, the Internal Revenue Service and the courts should put pressure on tax-exempt credit unions to provide small-dollar loan products. Finally, marketing companies should help small-dollar loan programs tell consumers about the more affordable alternatives to payday loans.

A. Critical Ongoing Role for Federal Regulators in Supporting Affordable Small-Dollar Loans

The CFPB needs to continue to take the lead in providing clear guidance to all lenders on appropriate features for small-dollar loans. The CFPB is forbidden from regulating interest rates by its enabling legislation, the Dodd-Frank Act. However, it can and has drafted a

172. Mehrsa Baradaran, *A Short History of Postal Banking*, SLATE (Aug. 18, 2014, 1:51 PM), http://www.slate.com/articles/news_and_politics/history/2014/08/postal_banking_already_worked_in_the_usa_and_it_will_work_again.html; see also OFFICE OF INSPECTOR GEN., *supra* note 166, at 5.

Payday, Vehicle Title, and Certain High Cost Installment Loans Rule that regulates other features of payday loans and that in its current form helps to make the market for small-dollar loans more competitive by encouraging banks and credit unions to enter the market with reasonably priced loans.¹⁷³

In addition, the OCC and NCUA should be applauded for their recent small-dollar loan guidance, and other prudential banking regulators should follow their lead.¹⁷⁴ As discussed above, banks and credit unions are the obvious players to provide small-dollar loans because they are already in the business of lending and already have payday loan borrowers as customers since a checking account is a prerequisite for obtaining a payday loan.¹⁷⁵ And yet, to date, neither banks nor credit unions have entered the market for small-dollar loans in significant numbers, in part because they need more clarity from their regulators. To give real choice to low- and moderate-income borrowers in need of immediate small-dollar credit, the market for small-dollar loans needs to become more competitive with payday lenders facing competition from banks, credit unions, non-profit lenders, and fintech lenders combined. The FDIC and the Federal Reserve should follow the lead of the OCC and NCUA and provide clear guidance on small-dollar loans to enable the financial institutions that they supervise to enter the small-dollar loan market. Guidance should include limits on the number of rollovers or the ability of borrowers to have multiple loans simultaneously, a requirement that banks timely report repayment history to the three major credit bureaus, credit underwriting that looks at a borrower's ability to repay, and a requirement that the loans carry affordable monthly payments of no more than 5% of a borrower's monthly income.¹⁷⁶

173. *Final Rule: Payday, Vehicle Title, and Certain High-Cost Installment Loans*, CONSUMER FIN. PROT. BUREAU, <https://www.consumerfinance.gov/policy-compliance/rule-making/final-rules/payday-vehicle-title-and-certain-high-cost-installment-loans/> (last visited Nov. 17, 2018); see also Bourke, *Momentum Is Building for Small Dollar Loans*, *supra* note 65.

174. See *supra* part IV.A.1.e.

175. See *supra* part IV.A.

176. See, e.g., U.S. DEP'T OF THE TREASURY, *supra* note 63; see also Bourke, *How CFPB Rules Can Encourage Banks*, *supra* note 43.

B. Community Reinvestment Act Examiners Should Encourage Banks to Fund Affordable Small-Dollar Loans

Banks are also subject to the Community Reinvestment Act (CRA), and the federal prudential banking regulators responsible for interpreting and enforcing the CRA should do so in a way that supports small-dollar loan programs. Federally insured banks are heavily involved in the payday loan industry. They provide capital to payday lenders and collect overdraft “protection” fees from account holders who have insufficient funds in their accounts, fees that resemble the predatory fees charged by payday lenders.¹⁷⁷ CRA examiners should penalize these harmful practices and actively encourage banks to assist small-dollar loan programs, including giving banks CRA credit for capital invested in affordable small-dollar loan programs.¹⁷⁸

The CRA is a 1977 federal law with a central goal of encouraging commercial banks and savings associations to meet the credit needs—not just the depository needs—of the community the institution serves, including low- and moderate-income households and neighborhoods, while also maintaining the sound operation of the institution.¹⁷⁹ The CRA covers banks and savings associations, including both national and state banks, whose deposits are insured by the FDIC. In passing the CRA, Congress expressed concern that individuals who were depositing their money with banks were not being served by those same banks when it came to lending and that banks were redlining certain neighborhoods by designating neighborhoods or housing located in certain neighborhoods and refusing to extend credit to those areas.¹⁸⁰

177. Peter Rudegeair et al., *Banks Take Hidden Subprime Path*, WALL ST. J. (Apr. 11, 2018), at B1 (describing the \$1.4 billion that Wells Fargo and Citigroup have given to payday lender Exeter Finance, LLC for its auto title lending, and the \$345 billion that banks lent to Exeter and other nonbank financial firms in 2017); Low, *supra* note 55 (estimating that banks and credit unions collected \$15 billion in overdraft and bounced check fees in 2016, based on filings showing that banks with over \$1 billion in assets collected a total of \$11.41 billion in overdraft and bounced check fees in 2016, and reporting that the average overdraft amount is just over \$20 and the average overdraft “protection” fee is \$34).

178. *See generally*, Kathleen C. Engel & Patricia A. McCoy, *The CRA Implications of Predatory Lending*, 29 FORDHAM URB. L.J. 1571 (2002) (recommending that the CRA be enforced to penalize covered banks that participate in predatory lending in low- and moderate-income neighborhoods); *see also Financial Institution Letter*, FED. DEPOSIT INS. CORP., <https://www.fdic.gov/news/news/financial/2007/fil07006a.html> (last updated Jan. 22, 2007) (stating that “[p]redatory lending can have a negative effect on a bank’s CRA performance . . . [F]inancial institutions are expected to help meet the credit needs of their entire communities, including low- and moderate-income areas.”).

179. 12 U.S.C.A. § 2901 (West 2009).

180. Darryl E. Getter, *The Effectiveness of the Community Reinvestment Act*, 1 CONG.

The CRA is enforced by the Office of the Comptroller of the Currency, the Federal Reserve System, and the Federal Deposit Insurance Corporation through annual CRA examinations of covered financial institutions.¹⁸¹ Covered financial institutions are evaluated based on three tests: the lending test, the investment test, and the services test. The lending test applies to small, intermediate, and large banks. The investment test applies to medium and large banks. The services test only applies to large banks. The lending test, which examines how frequently different income groups receive loans, is the only test that applies to all types of covered banks and is also the test that receives the most weight. The services test, which evaluates the availability and effectiveness of a bank's retail banking services, including loan production offices in low-income neighborhoods, has largely not put banks under substantial pressure.¹⁸² If a bank receives a favorable rating, then it will be evaluated less frequently. The results of CRA examinations may be taken into consideration by these same agencies when considering applications by those institutions for new bank branches or for mergers and acquisitions. An agency may use a poor CRA rating to reject a bank's application to expand its business or merge with another bank.¹⁸³ As a result of these incentives, "the rating system can help push banks into, or away from, certain activities."¹⁸⁴

Under the CRA, "regulated financial institutions have continuing and affirmative obligation [*sic*] to help meet the credit needs of the local communities in which they are chartered."¹⁸⁵ To bring payday lending into the CRA framework, regulators need to determine that

RES. SERV. 22 (Jan. 7, 2015), <https://www.newyorkfed.org/medialibrary/media/outreach-and-education/cra/reports/CRS-The-Effectiveness-of-the-Community-Reinvestment-Act.pdf>.

181. The Federal Reserve regulates state-chartered banks that are members of the Federal Reserve System. The Federal Deposit Insurance Corporation (FDIC) regulates state-chartered banks and saving banks that are not members of the Federal Reserve System. The Office of the Comptroller of Currency (OCC) regulates national banks. John Meeks, *An Introduction to the Community Reinvestment Act*, 1 FDIC CMTY. AFF. 60, 7-8, https://www.richmond-fed.org/~media/richmondfedorg/conferences_and_events/community_development/2012/cra_intro_050212.pdf (last visited Nov. 17, 2018).

182. Michael S. Barr, *Access to Financial Services in the 21st Century: Five Opportunities for the Bush Administration and the 107th Congress*, 16 NOTRE DAME J.L. ETHICS & PUB. POL'Y 447, 452 nn.7-8 (2002).

183. Pearl Chin, *Payday Loans: The Case for Federal Legislation*, 2004 U. ILL. L. REV. 723, 750 (2004).

184. Kenneth, *supra* note 4, at 695.

185. 12 U.S.C.A. § 2901 (West 2009).

banks located in communities affected by payday lending have a “continuing and affirmative obligation” to meet the need for affordable small-dollar loans in those communities.¹⁸⁶

The CRA can potentially serve as both a mechanism to penalize banks for involvement with the payday loan industry¹⁸⁷ and an incentive for banks to offer or help others to offer affordable small-dollar loans.¹⁸⁸ Affordable small-dollar loan programs that include best practice features should fit squarely within the CRA, since they are providing a much-needed alternative to low- and moderate-income households who would otherwise resort to payday loans. In fact, the guidelines for affordable small-dollar loans issued as a result of the FDIC pilot program note that “Institutions that provide such [affordable small-dollar loan] products consistent with these guidelines will receive favorable CRA consideration as outlined in the CRA section below.”¹⁸⁹ Favorable CRA consideration can be a valuable incentive for banks to enter the small-dollar loan market.¹⁹⁰ To determine which affordable small-dollar loan programs meet the goals of the CRA, regulators could start by looking to the FDIC’s own small-dollar loan template, described above in Part IV.A. The salient features of that template are an APR of 36% or less, a loan term of ninety days or greater, and a loan decision within twenty-four hours of the borrower’s application. Regulators could also consider extending favorable CRA consideration to institutions that offer affordable small-dollar loans with APRs above 36% but with monthly loan payments that do not exceed 5% of the borrower’s monthly income.¹⁹¹

Another area of consideration is expanding the coverage of the CRA to include credit unions. Credit unions were not included in the

186. Benjamin D. Faller, *Payday Loan Solutions: Slaying the Hydra (and Keeping it Dead)*, 59 CASE W. RES. L. REV. 125, 159 (2008).

187. See, e.g., Barr, *supra* note 182, at 462 (“To the extent that federally-regulated financial institutions are involved, regulators should pay particular attention to the problem of repeated refinancings [in payday lending]. In addition, as noted above, greater attention to the CRA services test could help shed light on bank practices in this area.”).

188. See, e.g., Chin, *supra* note 183, at 750 (“Partnerships with payday lenders should be a factor that lowers a bank’s CRA score.”); Faller, *supra* note 186, at 159 (“If banks offer appropriate [small-dollar loan] products, they should receive positive credit, as with the FDIC guidelines. If banks fail to meet the need, or offer inappropriate products, they ought to be penalized with negative evaluations of their practices.”).

189. *Financial Institution Letter*, *supra* note 178.

190. Faller, *supra* note 186, at 156.

191. See U.S. DEP’T OF THE TREASURY, *supra* note 63; see also Bourke, *How CFPB Rules Can Encourage Banks*, *supra* note 43.

CRA because, at the time of drafting, it was argued that they lacked the ability and incentive to engage in the practices by financial institutions that inspired the CRA. Credit unions were not-for-profit, relatively small in size, and limited to serving people of a common community.¹⁹² Credit unions, however, have changed dramatically since the passage of the CRA and now engage in business practices similar to those that banks engaged in when the CRA was enacted, with some even offering products comparable to payday loans.¹⁹³ As such, it may be appropriate to include credit unions within the coverage of the CRA and subject them to similar incentives.¹⁹⁴ In the alternative, credit union regulators, such as the National Credit Union Administration (NCUA) can push credit unions to honor their commitment to the communities they serve. The NCUA has moved in that direction in pressuring credit unions to obtain Community Development Financial Institution designation from the Department of the Treasury.¹⁹⁵

C. Financial Institutions, Foundations, and Private Investors Should Continue to Provide Affordable Loan Capital and Loan Loss Reserve Funds for Affordable Small-Dollar Loan Programs

Financial institutions, foundations, and private investors have a critical role to play in providing the initial and ongoing loan capital and loan-loss reserve funds needed to bring affordable small-dollar loan programs to market. As explained earlier, most banks are currently unwilling to enter the small-dollar loan program directly, citing the difficulty in making profits on unsecured loans below \$1000. For banks not willing to originate small-dollar loans themselves, they can instead help by lending affordable loan capital and loan loss reserve funds to other start-up and existing affordable small-dollar lenders. This loan capital can be extended because it is the right thing to do, because the borrowers it benefits may one day become the bank's customers for mortgages and other mainstream financial products, and because banks can obtain valuable CRA credit in return.

192. Cassity, *supra* note 115, at 338.

193. *Id.* at 334.

194. See e.g., Community Reinvestment Reform Act of 2018, S. 3503, 115th Cong. (2017-18) (proposed by Senator Elizabeth Warren) (including an expansion of the CRA to cover credit unions).

195. Telephone Interview with Aaron Duffy, *supra* note 83.

Banks, governments, and foundations can and should provide affordable loan capital to non-profit, small-dollar loan programs. The prestigious, annual NEXT Opportunity Award, which is a partnership of Wells Fargo, the Opportunity Finance Network, The John D. and Catherine T. MacArthur Foundation, The Kresge Foundation, and Prudential, has focused for two years in a row on innovative consumer financial services delivered by the CDFI sector. The CDFI sector includes non-profit and for-profit organizations that have obtained the CDFI designation from the U.S. Department of Treasury.

With 57% of Americans struggling with financial health, and a growing number of households turning to high-cost alternative financial products and services, CDFIs are needed more than ever to expand their role and provide this market with affordable and responsible products. . . . With 2016 financial support from Wells Fargo and Prudential, the 2016 NEXT Awards will continue a second year devoted to consumer financial services to build the critical momentum and visibility for CDFIs in this space. Consumer financial services includes loan products—small-dollar personal loans, credit building loans, auto loans, mortgage loans, and other loans for individual consumers—as well as other financial services such as savings products, debit and checking products, and financial education.”¹⁹⁶

Financial institutions may also have an important role as direct lenders in the non-profit small-dollar loan programs described in Part IV. Once the non-profit small-dollar lenders have done the hard work of designing, implementing, and proving a financially self-sustaining, affordable small-dollar loan program, financial institutions should be encouraged to join or take over these innovative small-dollar loan programs and bring them to scale.¹⁹⁷ Banks and credit unions are already in the business of lending, have an existing pool of borrowers who hold checking and savings accounts with them, have access to large amounts of loan capital, have a regional and national presence, and could

196. Press Release, Wells Fargo NEXT Awards for Opportunity Finance, <https://ofn.org/sites/default/files/resources/PDFs/2016%20NEXTAwards%20Flyer.pdf> (last visited Nov. 8, 2018). The two 2016 NEXT Opportunity Awardees are small-dollar lenders mentioned in this paper: The Community Loan Center Affordable Small Dollar Loans Program and the Appalachian Community Federal Credit Union. See NEXT AWARDS, <http://nextawards.org/> (last visited Dec. 22, 2018).

197. See e.g., Allison Daminger et al., *Driving Positive Innovations to Scale in the Financial Services Sector*, 1 IDEAS 42, 31 (2014), <https://www.ideas42.org/wpcontent/uploads/2015/05/Driving-Positive-Innovations-to-Scale-in-the-Financial-Services-Sector-August-Final.pdf> (describing challenges to bringing financial services innovations to scale and including specific recommendations for how to overcome these challenges).

quickly expand a successful small-dollar loan program to scale. By taking these programs to scale, financial institutions would capture the large volume that is necessary to make a profit on small-dollar loans with affordable interest rates and fees, take market share away from payday lenders, and make a real difference in the lives of low- and moderate-income families.

D. The Internal Revenue Service and the Courts Should Put Pressure on Credit Unions to Provide Affordable Small-Dollar Loans

Credit unions are not currently covered by the CRA and do not need to worry about passing that annual test. However, as tax-exempt entities, credit unions have a charitable purpose that should include providing small-dollar loans, especially given the finding that 20% of credit union members have taken out a payday loan. The federal and state agencies that oversee tax-exempt entities, and the federal and state agencies that oversee credit unions, should put pressure on credit unions to provide affordable small-dollar loans, including, but not limited to, the PAL Product and the Employer Sponsored Small-Dollar Loans Product discussed in Part IV.

Credit unions offer similar financial services and products to banks, but they differ in at least one, significant way: credit unions have the potential to be exempt from federal income taxes. IRS enforcement of credit union tax exemption can provide a mechanism for reining in high fees collected by credit unions and encouraging credit unions to offer affordable small-dollar loans.

Federal credit unions are automatically tax exempt under 501(c)(1) of the Internal Revenue Code, as long as they meet the requirements set forth in the Federal Credit Union Act, including the interest rate cap of 15% subject to adjustment by the NCUA.¹⁹⁸ State credit unions obtain their tax exemption under Section 501(c)(14)(A) of the Internal Revenue Code.¹⁹⁹ State credit unions, however, are not subject to the interest rate cap in the Federal Credit Union Act, but the interest rate caps, or lack of, in the state in which they are incorporated.

198. See Federal Credit Union Act of 1934, as amended by 12 U.S.C. § 1768; see also 12 U.S.C. § 1757(5)(A)(vi)(I) (establishing an interest rate cap for federal credit unions of 15% subject to adjustment by the Board of the NCUA); 26 U.S.C. § 501(c)(1) (2012) (exempting corporations established by federal law as tax-exempt instrumentalities of the United States).

199. 26 U.S.C. § 501(c)(14)(A) (2012).

For state credit unions, Section 511 of the Internal Revenue Code imposes a tax on the “unrelated business taxable income” (UBTI) of organizations otherwise exempt from federal income tax under Section 501(c)(14)(A).²⁰⁰ Section 512(a)(1) defines UBTI as “the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it.”²⁰¹ Section 513(a) adds that an “unrelated trade or business” is “any trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.”²⁰² One of the primary reasons behind Congressional enactment of the UBIT provisions was to prohibit unfair competition by tax-exempt entities against taxable entities.²⁰³

The IRS has issued guidance explaining that for a credit union’s activities to escape taxation as UBTI, the activities “must contribute directly and importantly to the accomplishment of one or more of [the credit union]’s exempt purposes—promotion of thrift and providing low cost credit for its members through mutual and nonprofit operation.”²⁰⁴ Federal courts have used a similar definition of a credit union’s exempt purpose. In *Alabama Central Credit Union v. United States*, the district court explained that a credit union’s exempt purposes “are to: (1) promote thrift among its members; and (2) create a source of credit for its members at legitimate rates of interest.”²⁰⁵ Likewise, the district court in *Community First Credit Union v. United States* explained that the tax-exempt purposes of a credit union “include encouraging thrift, providing fair credit, and providing an opportunity for members to improve their social and economic conditions.”²⁰⁶

The language used to describe a credit union’s exempt purpose—with its emphasis on the promotion of thrift, provision of fair credit, and improvement of social and economic conditions—can be read to exclude loans and overdraft fees with effective APR’s similar to payday

200. *Id.* § 511.

201. *Id.* § 512(a)(1).

202. *Id.* § 513(a).

203. *See* *Mueller Co. v. Commissioner*, 479 F.2d 678, 682 n.7 (3d Cir. 1973).

204. TECH. ADVICE MEMORANDUM FROM THE INTERNAL REVENUE SERV., TAM 200709072, (2007).

205. *Ala. Cent. Credit Union v. United States*, 646 F. Supp. 1199, 1201 (N.D. Ala. 1986).

206. *Cnty. First Credit Union v. United States*, No. 08-c-57, 2009 WL 2058476, at *1 (E.D. Wis. July 14, 2009).

loans. Under such an interpretation, credit union income from those loans and fees would be taxed. Affordable small-dollar loans offered by credit unions, on the other hand, further credit unions' exempt purpose and should be tax exempt. Accordingly, credit unions can obtain tax exemption on "the provision of savings accounts and loans to members who might not be served by banks in a nonprofit and mutual manner."²⁰⁷ In fact, the IRS writes in an explanation of 501(c)(14)(A) that "a major reason for the establishment of credit unions in this country was to provide their members with a source of personal loans, in small amounts and for a short term, which generally were difficult to obtain from other financial institutions, absent the payment of usurious interest rates."²⁰⁸

In application, courts have been permissive in their interpretation of the credit union activities that are substantially related to the exempt function.²⁰⁹ Nonetheless, the potential exists for the IRS to use UBTI to tax income to credit unions from expensive loans and overdraft fees.

E. Marketing Companies Should Help Borrowers Learn About Affordable Small-Dollar Loans

In May of 2016, Facebook and Google announced that they would no longer accept advertising dollars from payday lenders.²¹⁰ Google's advertising policy states that it will not advertise personal loans with repayment in full due in less than sixty days or personal loans with an

207. John V. Woodhull & Janice M. Smith, *Tax-Exempt Credit Unions – Why is Their Tax Status So Controversial?*, TAX'N OF EXEMPTS, 26, 29 (2014).

208. STATE CHARTERED CREDIT UNION UNDER 501(C)(14)(A), 1979 IRS EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (1979).

209. See *Beelco Credit Union v. United States*, 735 F. Supp. 2d 1286 (D. Colo. 2010) (holding that income from the sale of life and disability insurance was not subject to UBTI because it was substantially related to the credit union's exempt purpose); *Cnty. First Credit Union*, 2009 WL 2058476 (jury finding that the sale of life, disability, and automobile insurance was not subject to UBTI); see also, INTERNAL REVENUE SER., TAX EXEMPT AND GOV'T ENTITIES DIV., CONTROL NO: TEGE-04-0324-0005, MEMORANDUM TO ALL EXEMPT ORGS. EMPS. (2015), <https://www.irs.gov/pub/foia/ig/spder/TEGE-04-0314-0005%5B1%5D.pdf> (stating that federal credit unions are not subject to UBIT and that state-chartered credit unions are subject to UBIT but the income from the sale of a delineated number of products is not subject to UBIT, including interest from credit card loans, debit card program's interchange fees, and credit card program's interchange fees).

210. Andrea Peterson & Jonnelle Marte, *Google to Ban Payday Loan Advertisements*, WASH. POST (May 11, 2016), https://www.washingtonpost.com/news/theswitch/wp/2016/05/11/google-to-ban-payday-loan-advertisements/?utm_term=.c0f1065519ba.

APR at or greater than 36%.²¹¹ The impact of these new policies could be quite large since payday lenders reach a large number of their borrowers through online advertising, part of which attracts borrowers to brick and mortar payday loan storefronts and part of which attracts borrowers to payday loans offered online. Critics claim that the companies are not adequately enforcing their advertising policies and that payday lenders are continuing to advertise on these platforms.²¹² While enforcement remains critical, the private sector should be applauded for stepping in voluntarily to regulate these harmful financial products.

The private sector could go one step further and advertise the small-dollar loan programs described in Part IV, especially since marketing costs are such a high cost to small-dollar lenders.²¹³ NerdWallet is doing just that and is doing it well. NerdWallet's website includes easy-to-read information about small-dollar loans and includes a search engine that provides borrowers with a list of affordable small-dollar loan products in their geographic area. The company carefully vets small-dollar lenders before including them on its website. NerdWallet has a team of researchers and writers who are engaged in national and local conversations about payday loans. Since high marketing costs are one of the factors that make it hard to offer an affordable small-dollar loan, subsidized marketing fees for affordable small-dollar loans would help alternative small-dollar lenders gain ground on payday lenders.²¹⁴

VI. CONCLUSION

The failure of monthly income to keep up with monthly expenses for a huge number of low- and moderate-income American households is a critical social issue. Payday loans are part of the challenge for low- and moderate-income households in America. Focusing on market alternatives that offer truly affordable access to credit is worthwhile.

211. *Financial Products and Services*, GOOGLE SUPPORT, <https://support.google.com/ad-words/policy/answer/2464998?hl=en> (last visited Nov. 8, 2018).

212. Kevin Wack, *Payday Lenders are Finding Ways Around Google's Ad Ban*, AM. BANKER (Oct. 11, 2017, 12:39 PM), <https://www.americanbanker.com/news/payday-lenders-are-finding-ways-around-googles-ad-ban>.

213. Telephone Interview with Jeff Zhou, *supra* note 133 (describing marketing costs as one of the company's biggest expenses).

214. *Id.*

Affordable small-dollar loan programs have been growing over the past ten years, started by financial institutions, by non-profit organizations, and by the fintech sector. The public and private sectors should continue to lend their financial support to these affordable small-dollar loan programs because these programs are helping consumers, are financially sustainable, and need to be brought to scale. Federal regulators should continue to support the provision of small-dollar loans by banks and credit unions. Consumer advocates should continue to support affordable alternatives and should consider whether the 36% cap is high enough to bring alternatives to scale. Working together, the public and private sectors can help give low- and moderate-income Americans the affordable credit they need and save them from the serious harms of payday loans.