Small-Dollar Loans: An Update

regulatory lending pandemic

Summary: Bank of America recently announced it was adding small-dollar loans to its offerings. Should you?

In 1916, the first Uniform Small Loan Law allowed up to 3.5% monthly interest on loans of $300 or less. From there, two-thirds of states implemented similar versions of it. While these loans have not often been embraced by FDIC-insured financial institutions (FIs), this sentiment may be changing.

Most recently, Bank of America made headlines with the announcement that it was getting into the payday loan market. Customers can now borrow up to $500 (in increments of $100) for a $5 flat fee regardless of the amount advanced to their account. Digital bank Varo, followed suit shortly after, announcing advances for qualifying customers of up to $100. Some other financial institutions (FIs) are already doing this, but these recent announcements suggest there's more to come.

Regulatory guidance. That's partly because banking regulators have been encouraging FIs to offer responsible small-dollar loans to consumers and businesses, especially amid the pandemic, which has made quick access to cash especially important for many cash-strapped companies and families. In May, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the National Credit Union Administration issued interagency guidance on this very topic. And in July the Consumer Financial Protection Bureau issued its long-awaited final rule, removing certain hurdles for institutions in the small-dollar lending space.

Helping customers. For many years, the payday loan market has been viewed as predatory and sometimes misleading to borrowers, which is why regulators and banks are stepping up -- to help ensure advances are offered in a responsible way to customers. When properly administered, these programs should result in a high percentage of customers successfully repaying their debt and should aim to minimize the risk that customers will sink deeper down the debt rabbit hole, according to the interagency guidance. In offering small-dollar loans, community financial institutions (CFIs) should pay close attention to loan structures, loan pricing, underwriting, marketing and disclosures as well as servicing and safeguards, as with all loans.

The balance for CFIs. Some CFIs already have small-dollar loan offerings among their product line-up, but it's still a relatively small number. Households and small businesses may need these loans right now, but many CFIs may feel that the risks are too high, or perhaps too unfamiliar. That said, research by the Center for Financial Services Innovation (CFSI) found that 85% of bank deposit advance borrowers were able to repay their first loan on time (without overdrawing their checking account) vs. 60% of payday loan borrowers. Assessing your customers properly ahead of time is key.

The other challenge is profitability. To make small-dollar loans profitable, you may need to partner with a fintech or find another way to leverage technology. Making this offering efficient will make it more profitable and help with regulatory transparency too.

Whether you provide small-dollar loans or not, we hope that this update has given you some information about what other lenders are doing in today's marketplace.

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