Small-Dollar Loans Are a Win-Win Payday Loan Alternative

payday loans lending

Summary: Over the last few years, several large and regional banks have started offering small-dollar loans to their cash-strapped customers. Is a payday loan alternative something your CFI might consider?

Imagine this scenario: a student at a college in New York gets the news that his mother, at home in Arizona, has suffered a serious heart attack. He needs to travel home to see her right away, but he doesn't have enough savings to purchase a plane ticket for a trip across the country. He also doesn't have a credit card that can cover the price of the ticket.

If he has a job, he could go to a payday lender. But a typical payday loan might have carried an annual percentage rate of nearly 400%, according to the Consumer Financial Protection Bureau. If his job doesn't pay that much in two weeks, the interest rate would go up and the lender would likely add penalty fees, making it less and less likely that he will ever successfully pay back the debt.

In fact, payday lenders collect 75% of their fees from borrowers with more than 10 loans per year. Their business model relies on the long-term debt cycle.

Payday alternative loans help both CFIs and borrowers.

By contrast, a payday alternative loan from a community financial institution (CFI) might carry an interest rate of between 12% and 30%. This would be an enormous savings for the borrower, while also giving the CFI both a profit and an opportunity to broaden its relationship with a customer.

Unlike standard CFI loans, which lenders approve or deny based on a customer's credit rating, payday alternative loans get a thumbs up or down because of a customer's cash flow. CFIs look at routine banking activity — regular or direct deposits, using accounts frequently for payments — to determine a potential borrower's ability to repay a loan. Because that information is at most a few months old, it often says more about whether someone is currently a good lending risk than a credit score, which is impacted by financial information from years in the past.

Alternative loans are gaining popularity.

Many financial institutions have become payday alternative lenders since the FDIC, OCC, the Board of Governors of the Federal Reserve System, and the NCUA issued 2020 guidance on offering small installment loans. Six large and midsize banks offer loans of $5 to $1K: Wells Fargo, Truist Financial, US Bancorp, Regions Financial, Bank of America, and Huntington Bancshares. Other banks are planning their own small-loan products, and those that already have them are finding success.

"They're reaching a lot of customers they've never reached before — people who have used payday loans, people who have overdrafted, people whose credit scores would not qualify them for a credit card," says Alex Horowitz, who tracks the issue at the Pew Charitable Trusts.

Here's what CFIs need to issue payday alternative loans.

To offer your customers a similar type of small loan might be feasible with your current staff, but in some cases, a partnership with a third-party provider can help cover the cost of writing small-dollar loans. Upstart, a fintech company that specializes in payday alternative loans, partners with dozens of CFIs to offer these loans to CFI customers in a cost-effective way. Their loan application process is entirely digital and can approve loans quickly using artificial intelligence. Of course, you'll need to do your due diligence to ensure that any partnership you engage in meets the right criteria for your CFI.

According to Pew, a successful payday alternative lending program has four primary elements:

1. **Access.** Financial institutions that offer these small loans typically require that borrowers have at least 3 months (or as many as 12 months) of account history with the lender. Beyond that, Pew says that CFIs should steer customers who don't qualify for other loans and are good bets to repay a payday alternative loan, based on their account history.
2. **Affordability.** CFIs should offer loan repayment over at least three months and loan sizes that account data suggest will be manageable for borrowers. US Bank limits payments to 5% of a borrower's income, to make sure repayment is affordable for the customer.
3. **Fair pricing.** CFIs should price loans low enough so that total cost is a small fraction of the principal, but high enough that the CFI earns a reasonable profit and creates a sustainable program. Borrowers are not in a position to shop around for a loan, because of the requirement that they have an account history with their lender. CFIs should remember that these customers are somewhat at their mercy.
4. **Speed.** Payday alternative borrowers are typically in a tight financial spot, so they need money quickly. They are happiest with a quick, intuitive application process that uses online and mobile banking interfaces, and with funds provided the same day that a loan is approved.

On a CFI's side, it makes sense to automate as much as possible of the loan process, to avoid using precious employee time. This, too, can help keep payday alternative loans affordable. Automated payments are convenient for customers while also helping ensure that the loan is repaid.

As payday alternative loans become more common, they have the potential to help the most underserved customers: people with no credit history, immigrants, people of color, and those under age 30. By offering payday alternative loans, CFIs can help meet the needs of underserved customers and protect a community from predatory payday lending. They can also help CFIs turn a profit while broadening their relationships with borrowers.

LOOKING TO GROW YOUR LOAN PORTFOLIO?

ECONOMY & RATES

Rates As Of: 12/04/2023 07:42AM (GMT-0800)

Treasury	Yields	MTD Chg	YTD Chg
3M	5.43	-0.02	1.01
6M	5.33	-0.05	0.57
1Y	5.08	-0.04	0.38

2Y	4.64	-0.04	0.21
5Y	4.23	-0.04	0.23
10Y	4.29	-0.04	0.41
30Y	4.45	-0.04	0.49

FF Market	**FF Disc**	**IORB**
5.33	5.50	5.40
SOFR	**Prime**	**OBFR**
5.39	8.50	5.32