Fair Small Dollar Lending

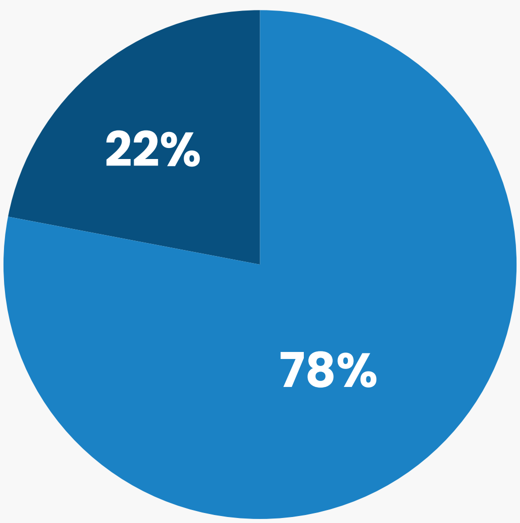
A Pathway to Financial Wellness

QCASH®

Executive Summary

Even before the pandemic took hold in early 2020, the Federal Reserve estimated that **40 percent of Americans couldn't afford an unexpected event that cost more than $400**. In the wake of COVID-19 came massive job layoffs — giving rise to a nearly 14 percent unemployment rate. Congress later passed the unprecedented American Rescue Plan Act placing approximately $391 billion into the hands of some 167 million Americans in the form of stimulus checks.

According to the Federal Reserve Bank of New York, as of March 2021 U.S. households used roughly one-third of their stimulus checks to pay down debt. For families earning less than $40,000 a year, that metric increased by nearly 10 points. And while the unemployment rate has dropped considerably to below six percent as of August 2021, there remains millions of Americans with bad credit ratings facing mounting bills with no future stimulus checks to count on. These underbanked consumers are forced to apply for small dollar loans ranging between $300 and $5,000 from predatory lenders, some of which charge upwards of 500 percent (or more) in interest rates.



22 percent of American adults (63 million) are either unbanked or underbanked.

"A 2019 Federal Reserve report found that 22 percent of American adults (63 million) are either unbanked or underbanked," said Alison Carr, chief strategy officer for the Sumner, Wash. – based Your Credit Union Partner, which helps mid-sized and smaller credit unions grow, become more efficient, while increasing profitability.

"Of this, six percent of Americans are unbanked and have no bank account whatsoever and must rely on alternative financial products and services, such as payday loans, check cashing services, money orders and pawn shop loans to take care of their finances," said Carr. "The remaining 16 percent of Americans are considered underbanked, having some sort of bank account, but also relying on alternative financial services."

While the statistics for the aforementioned banking demographics can be viewed as grim, a win-win opportunity exists for credit unions to adopt a white label, instant-approval small-dollar loan solution that fairly serves existing members as well as prospective members.

“This is where credit unions can really make a difference. We are locally owned financial cooperatives that are embedded in these communities or have deep connections to them,” said Pablo DeFilippi, senior vice president of Membership and Network Engagement for the New York City –based Inclusiv, a leading financial inclusion and community development advocate for the credit union industry.

“We must rethink our business model and adapt to these market shifts. Let’s change the stereotype of what a ‘good borrower’ is and stop seeing risk in these demographics and embrace the opportunity they represent for our future and relevance.”

The purpose of this white paper is to inform credit union executives on financial wellness and counseling practices that best serve membership, especially those members with credit scores lower than 650 who traditionally have been forced into predatory lending practices. Additionally, the case will be made for why a cost/benefit analysis shouldn’t be the deciding factor on whether to offer a fair small dollar lending solution. Ultimately, the white paper will answer the question: How can a fair small dollar loan solution benefit a credit union and its membership?

Differentiating between Predatory Lenders and Fair Small Dollar Loans

According to The Consumer Financial Protection Bureau (CFPB), 32 states currently allow small dollar lending. And while many of these states set maximum interest rates for small dollar loans or impose other restrictions or limitations on their use, borrowers with bad or no credit are often preyed upon.

A typical payday loan, as defined by the CFPB in its “Examination Procedures for Short-Term and Small Dollar Lending” report, bridges a cash-flow shortage between pay or benefits checks. The Bureau noted that the majority of payday loans can be broken into three categories: the loans are small dollar; borrowers must repay loan proceeds quickly (i.e., short-term loan); and they require that a borrower give lenders access to repayment through a claim on the borrower’s deposit account.

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1. **Loans are small dollar**
2. **Borrowers must repay loan proceeds quickly**
3. **Require borrower give lenders access to repayment**

“Most loans are for several hundred dollars and have finance charges of $15 to $20 per each $100 borrowed,” the report stated. “For the two-week term typical of a payday loan, these fees equate to an annual percentage rate (APR) ranging from 391 percent to 521 percent. Loan amounts and finance charges can vary due to factors, including differences in state law.”

With such high APR rates, most borrowers can only pay the interest on a loan and are rarely able to pay down the principle. This unwillingly forces borrowers into a predatory cycle where they are taking out more payday loans not to pay for the services they desperately need, such as groceries and utilities, but rather to pay down previous loan balances.

Underbanked Americans

According to the Financial Health Network’s report “Sizing the Financially Underserved Market,” unbanked and underbanked Americans spent $189 billion in fees and interest on financial products in 2018, which was the latest year for data, explained Your Credit Union Partner’s Founder Scott Butterfield. “Using the Federal Deposit Insurance Corporation’s estimate that some 63 million Americans are unbanked or underbanked, that would be an average of $3,000 in annual costs per person,” noted Butterfield who is a trusted advisor to more than 200 credit unions across the nation. “As high as these costs are, they are only the direct costs that unbanked and underbanked households face. There are a number of indirect costs that can have even greater consequences."

Predatory lenders extract wealth from low-income communities, said Inclusiv's DeFilippi. He added that the "elephant in the room" is the correlation between race, ethnicity and lack of economic mobility.

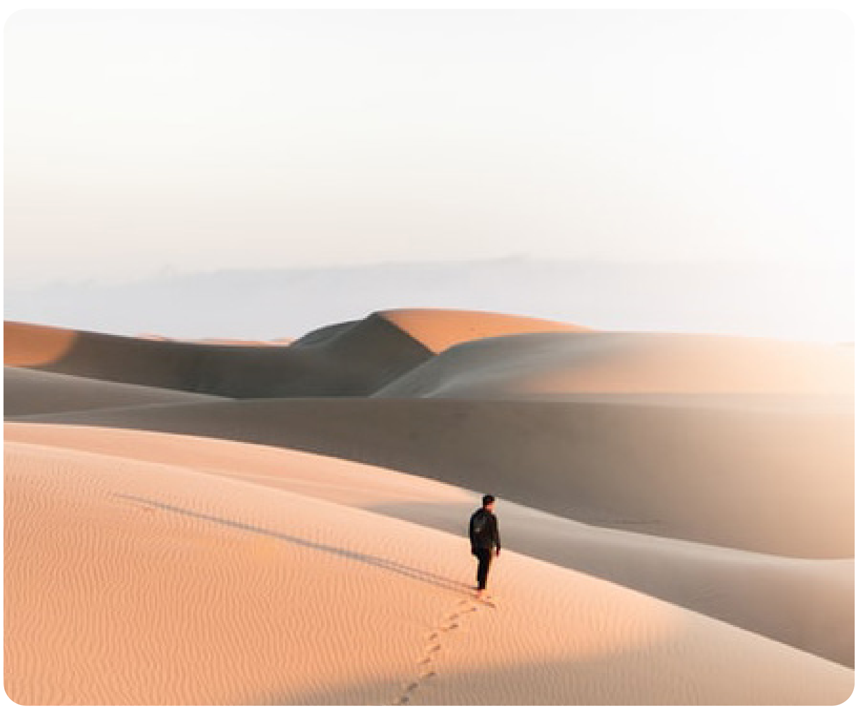
Systematic Barriers

"Black and brown communities face systemic barriers that have impacted their ability to build wealth. Those communities are also the first ones to be affected by economic downturns. In fact, these communities still haven't recovered the wealth they lost during the Great Recession," he added.
Since its inception in 1974, Inclusiv's mission has been "true financial inclusion" and that "empowerment is a fundamental right." The organization advocates for its member community development credit unions (CDCUs). Over the years, the organization has played pivotal roles helping create a regulatory and business model framework based on the National Credit Union Administration's (NCUA) low income designation; the community development financial institution (CDFI) certification (given by the Treasury Department's CDFI Fund); and more recently the NCUA's Minority Depository

Institution (MDI) designation, and the national expansion of the Juntos Avanzamos designation.

“Our network of CDFIs has reached milestones every year. In 2019, we hit 300 members. This year our network reached 400, serving 14 million consumers in 46 states, Washington D.C and Puerto Rico. They have combined assets of over $190 billion,” noted DeFilippi. “We will be a 500-member credit union network next year.”

Inclusiv’s efforts are not only warranted but necessary. An unbanked person, for example, with an average income of $20,000 or less will spend $1,200 a year on check cashing and money orders, and over $40,000 in unnecessary banking fees in their lifetime, explained DeFilippi. Consumers with low or no credit scores, he added, may pay $200,000 or more over a lifetime for financial products and services than those with good credit scores.



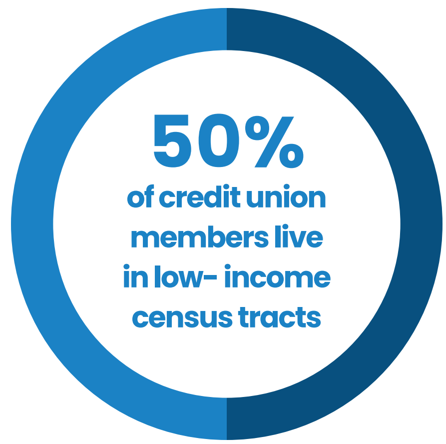
Predatory lending practices, such as targeting low-income neighborhoods, are usually coupled with traditional benchmarks like evaluating a person’s credit score. While the latter has long been a litmus test for determining loan terms and eligibility, this approach is antiquated, explained QCash Financial’s CEO Seth Brickman. The Olympia, Wash. – based Credit Union Service Organization has offered a white label, fair small dollar lending solution to credit unions since 2015.

“A credit score is a tried and proven method for mitigating risk on a loan, but QCash doesn’t use credit scores,” said Brickman. “QCash uses relational underwriting that completely opens up an entirely new capability for credit unions to give loans to people, but that doesn’t mean that the risk is the same — the risk is slightly greater. And anytime you have an increased risk, you have increased costs associated with that risk.”

Since risk does exist with even “fair practice” payday loans like QCash’s solution, Brickman said determining a reasonable APR is sometimes difficult; however, there is guidance apart from relational underwriting criteria. The U.S. government, for example, provides direction. As such, federally chartered credit unions must offer an APR of 28 percent or lower on all loans.

“Ensuring members are treated fairly and have access to the funds they need when the life event that caused the need is happening is our primary goal. We want these members to go to their credit union where they are known and cared for and will get the help they need in a responsible manner,” said Brickman. “We define fair small dollar lending as giving people access to capital when they need it at a reasonable interest rate based on the increased risk of that loan.”

The NCUA finds that more than 50 percent of credit union members live in low-income census tracts. Carr said credit unions have a “huge opportunity” to expand financial wellness and small dollar lending practices. And interest in community development is growing among credit union leaders, she added. To this end, there are more than 350 CDFIs, 540 MDIs, and nearly 120 Juntos Avanzamos designated credit unions.



“It’s in credit union’s DNA and considering the options to truly differentiate, such as consistently providing for the best technology, most convenient branch footprint, commoditized product offers, credit union leaders are finding that a focus on financial wellness and inclusion are the best ways to be truly different and better,” said Carr. “Credit unions are the original financial inclusion advocates.”

Practical Small Dollar Lending Practices

As of July 2021, QCash has funded over 600,000 small dollar loans in the credit union space, ranging from $50 to $4,000. The platform, however, is not limited to traditional small-dollar loans, and can also be used to automate other unsecured loans, such as personal loans, pre-approved loans and lines of credit.

Prior to launch, QCash used Washington State Employees Credit Union (WSECU) as an incubator for its small dollar loan alternative technology. During this time frame of roughly 10 years, WSECU made over 300,000 short term loans for over $200 million.

Excellent Continued Service

Today, QCash continues its original mission by offering credit unions the ability to grant short-term, small dollar loans to members. The automated, fully configurable solution allows a credit union to instantly offer small dollar loans that are relationship based, explained Brickman. While some credit unions require six to eight weeks to rollout the solution, other organizations are up-and-running in less than two weeks. The time difference, he noted, depends on a credit union's staffing and technology stack.

"We are a digital platform, so we are available 24 hours a day, seven days a week. Members can literally go from clicking a link to apply for the loan to funds in their account in under 60 seconds," said Brickman. "We meet the need of the member when the need is actually occurring – not the next day or the next time the branch is open."

Brickman noted that it is due to QCash's long history of investment and advocacy that the organization is well-suited to offer credit unions a solution that will meet the practical small dollar lending needs of membership. Among lessons learned along the way is that QCash's solution isn't meant to be a lending turnstile, but rather a first step toward financial solvency. When members pay back a loan on time or faster, for instance, their financial standing in the credit union is viewed as more favorable.

"Financial wellness education is very important for the underbanked and underserved, but is only important to them once the immediate need has been met. These people have life events that require a short-term infusion of capital," said Brickman.

"And it's great to educate them on ways to get out of a pattern of financial destruction and onto the path of financial wellness, but is better received when you have an actual product that can meet the needs for that underbanked person for the situation that they are in."

Educating and encouraging the underbanked is a foundational principle at Inclusiv. To this end, DeFilippi said that credit unions should provide fair alternatives to payday loan products within the allowable rates established by NCUA. He added that communities across the country are desperate for credit unions to offer fair lending practices.

"This is where we can turn around the Fintech threat. We can and should find scalable options to provide relief to consumers at a price point that is both sustainable to us but also responsible to consumers," he said. "The goal is to move people away from payday lenders by giving them access – when they are ready – to the tools we provide and that we're instrumental in enabling the emerging of the American middle class."

As the fallout from the pandemic continues, and as the country collectively looks for what the new normal will be in respective spaces, access to CDFI grants offer eligilbe credit unions a transformantional opportunity to dramatically expand their capacity to meet these historically financially underserved communities. Enacted in 1994, the CDFI fund has become the single largest source of external resources available for mission-driven, community development credit unions, explained DeFilippi.

"This year, and in recognition to the incredible, truly heroic work of credit unions, which so effectively responded to the needs of their members and communities impacted by the pandemic, including those that became PPP lenders almost overnight, we are seeing an unprecedented level of resources coming to support this work," he said.

In June 2021, the CDFI Fund announced that 244 credit unions received more than $400 million as part of its "Rapid Response Program." Conversely, only 149 banks received $267 million, which places credit unions in a more favorable lending position. Additionally, the Treasury Department continues to accept applications for its Emergency Capital Initiative Program, which has an estimated $9 billion available to make secondary capital investments. The CDFI Fund, noted DeFilippi, still has approximately $1.75 billion available for grant making purposes.

"All these resources have one goal: Increase lending in high need communities," he said. "This is the time to double-down our impact lending. There's capital and resources to stop payday lenders once and for all. If not now, then when?"

CDFI and similar grant programs will continue to play an important role in supporting responsible small dollar lending practices, said Butterfield. These grants, he explained, provide capacity building opportunities, with technical assistance funding being used to design, improve or scale programs.

"Financial assistance grants are being used to increase net worth levels and/or loan loss reserves to cover the perceived higher risk of small balance lending. Credit unions are also leveraging grant funding to train financial educators to provide education and coaching to support their small balance lending to develop better informed borrowers," noted Butterfield. "They are also using grant funds to pay for additional lenders or collectors if needed. These resources are building sustainable lending platforms that create an affordable alternative to predatory lending."

While government sponsored grants are a boon for the responsible small dollar loan movement, there exist other worthwhile applications, such as loans for rental assistance. Due to the pandemic, Carr said access to affordable housing is increasingly competitive and many credit union members are in need of assistance.

"With low inventory and longer waiting lists, consumers must be ready with deposits and first and last month's rent. Many low-and moderate-income consumers are challenged with funding," said Carr. "And many consumers use credit cards with high interest rates to fund these loans. There is an opportunity for credit unions to provide this smaller dollar loan and then follow up later with first-time home buyer training and mortgage financing when the time is right."

Conclusion: A Credit Union Call to Action

As an industry, credit unions are defined by the ethos: People Helping People. It is this same philosophy – a guiding principle – that DeFilippi said should be applied to lending practices.

"Small dollar lending is the perfect product to put that principle into action. Payday lenders extract billions of dollars from communities across the country, often times from credit union members. It's time to stop the bleeding, to step in and to give those communities a chance to rebuild themselves," said DeFilippi. "We're the ultimate lending circle — the most sustainable financial institution model where we are not accountable to external interests, just to our members and the communities where they live. Through our research, which is substantiated by our growing membership, we've proven that financial inclusion is not only sustainable, but an engine of growth and relevance for mission driven credit unions."

In order to be a sustainable model, Butterfield said that small dollar lending must be automated. And while providing non-predatory rates is "mission focused," he said low rates are frequently not sustainable in non-automated systems.

"QCash automates this process so that the credit union staff can spend more time providing financial advice and coaching to members and receive a fair margin on the small balance loan that is being underwritten," said Butterfield. As Brickman looks forward, he said the QCash team is fielding increased interest from credit unions across all asset classes that are looking for a small dollar lending solution that treats members fairly.

"We are seeing more credit unions getting CDFI grants than ever before and are also seeing more credit unions trying to figure out how they can better service their members. They are looking for partners in this space," said Brickman. "The growth rate is amazing right now and it's because credit unions are realizing that their members have lending needs that aren't currently being met."

About the Author

Over the past 17 years, W.B. "Brad" King has served as a technology writer, columnist and correspondent for Credit Union Business magazine and the Credit Union Journal. He has written on technology topics for leading industry companies and organizations, including The Credit Union National Association. Additionally, he is a co-founder of the credit union-focused technology publication, Finopotamus. Outside of the credit union industry, he has ghostwritten and authored numerous books on a wide range of subjects and is an award-winning journalist who has taught writing courses at New York University."