



BSG Financial Group™

The big payoff from small dollar loans



Financial institutions (FIs) determined a long time ago that it was hard to earn a profit making consumer loans for a few hundred dollars. As Mark Pearce of the FDIC commented in 2012 on reviewing the FDIC's Small Dollar Loan Pilot started in 2008, "the interest income and fees generated were not always sufficient to achieve short-term profitability." And equally daunting are fears about how to steer clear of regulatory concerns with the recent CFPB, FDIC and OCC moves against any form of bank payday or advance lending.

Yet, the market demand for small dollar loans under \$1,000 is large and growing. Our research shows existing bank customers pay nonbank providers nearly the equivalent of what FIs earn in overdraft fees for small-dollar loan services, and these customers are not paying overdraft fees. For the most part, this customer segment does not use high annual

percentage rate (APR) payday loans but rather accepts other alternatives such as late payment fees. Fortunately for them, this market for small dollar loans and alternatives has been disrupted and remade in recent years through better product design, alternative underwriting and improved online service and protection for consumers.

At a time when FIs are struggling with a profitable consumer business model, we believe small dollar loans offered through these new approaches represent a new growth market. For example, while regulators are rightly cracking down on any bank doing payday loans, several institutions are building profitable new business models and avoiding regulator problems. Key Bank offers "KeyBasic," which avoids payday loan issues with its small dollar loan account, and BankPlus in Mississippi successfully offers a small dollar loan called Credit Plus. First Federal Savings Bank in Kentucky is winning customers with its low interest Credit Builder Checking Program and One Pacific Coast Bank is building interest in its small dollar loan "PAL" program. A full list of small dollar loan programs can be found at The Equitable Bank Website.

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Meanwhile, non-bank competitors, such as BillFloat, FlexWage and Float Money, are pioneering disruptive Internet models that leverage account aggregation data and lower cost online delivery. Small dollar loan growth is fastest with these non-bank providers, with BillFloat reaching 700,000 users in just two years. Perhaps the biggest opportunity is for FIs to partner with disruptive innovators such as BillFloat to deliver profitable and regulatory-compliant services to grow revenues. While many of the bank and non-bank players mentioned above have unique strategies, they all leverage one or more of the following three features:

Acceptable APR, fees configuration and repayment. APRs on these new small dollar loan strategies range from 5% to 36%, yet they all fit within the guidelines for rate and repayment as published by the FDIC Small Dollar Loan program or the National Consumer Law Center. Repayment is always over several months or associated with a line of credit rather than a single repayment. Fees also vary with monthly participation fees, transfer fees and late fees where appropriate but in all cases at a much lower cost than the ongoing use of payday and advance loans.

Alternative underwriting to serve and protect a broader base of customers.

Knowing and assuring a consumer has the ability to repay any loan taken is fundamental to responsible lending. However, increasing evidence shows that traditional credit scores can be misleading, particularly for a consumer requesting to borrow just a few hundred dollars to be paid back over several months. A growing number of firms like ZestCash and LendingClub are successfully using alternatives to assess a consumer's ability to repay. Factors such as paying utilities on time and regularity of deposits in checking accounts show a high correlation with successful small-dollar loan use. Financial institutions are increasingly using their extensive deposit data on customers to accurately measure consumer cash flow, regularity and risk to safely underwrite small dollar loans.

Automated Web-enhanced delivery reducing cost and simplifying processes.

Just as the Internet can deliver music for 99 cents a song much less expensively than buying a CD in a record store, the online process can be used for loan access, application and servicing more efficiently than could be accomplished through paper applications and in-branch visits. The Internet provides the opportunity to leverage the two benefits of simplification and alternative underwriting. Highly targeted Web sites can provide simple, specific loan alternatives in a self-service manner for the consumer 24 hours a day using automated and immediate alternative underwriting systems. The mechanics of applying for a loan, linking information through account aggregation and receiving the needed funds in the correct account can all be automated for completion in a manner of minutes. Further, the use of the funds to pay a bill, transfer to another account or send to a person can be easily accomplished through most online banking systems. The entire process is simpler and faster.

Small dollar loans services are experiencing a renaissance with these new tools, generating better service for consumers, salutary public policy and profits for providers. FIs should make sure they participate in this market opportunity.

To learn more about our Digital Lending solutions, please contact
BSG Financial Group at (866) 274-8900 or go to <http://www.BSGFinancial.com>.

