Banks Given Green Light for Small-Dollar Loans in Response to COVID-19

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For many years, small-dollar lending has been the focus of regulatory concern and, in some cases, disapproval. The advent of the COVID-19 pandemic and resulting financial distress experienced by many Americans have prompted regulators to take a fresh look at these types of loans, and now may be the time to adopt a small lending program.

On May 20, 2020, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration and the Office of the Comptroller of the Currency issued interagency principles "to encourage supervised banks, savings associations and credit unions to offer responsible small-dollar loans to customers for both consumer and small business purposes." The federal banking agencies recognize the important role that small-dollar loans can play in "helping customers meet their ongoing needs for credit due to temporary cash-flow imbalances, unexpected expenses, or income shortfalls, including during periods of economic stress, national emergencies or disaster recoveries." With the U.S. unemployment rate at 14.7% in April and expected to hit 15% by the end of the second quarter, traditional banking institutions have been given the green light from federal regulators to provide small-dollar lending to assist customers financially impacted by the COVID-19 pandemic.

The federal banking agencies issued the interagency principles following a joint statement issued by the Consumer Financial Protection Bureau (CFPB) and the federal banking agencies March 26 that encouraged small-dollar lending in response to the COVID-19 pandemic. In the joint statement, the CFPB and the federal banking agencies encouraged financial institutions to make responsible small-dollar loans to both consumers and small businesses through a variety of loan structures such as open-ended lines of credit, closed-end installment loans, or appropriately structured single payment loans. Financial institutions were also encouraged to consider workout solutions designed to help enable the borrower to repay the principal of the loan while mitigating the need to reborrow. In the statement, the federal agencies noted that they were working on additional guidance and lending principles for responsible small-dollar loans to assist financial institutions to more effectively meet the ongoing credit needs of their communities and customers.

Characteristics of Responsible Small-Dollar Loan Programs

The interagency principles identify the following three characteristics of responsible small-dollar loan programs:

- A high percentage of customers successfully repaying their small-dollar loans in accordance with original loan terms, which is a key indicator of affordability, eligibility and appropriate underwriting;
- Repayment terms, pricing and safeguards that minimize adverse customer outcomes, including cycles of debt due to rollovers or reborrowing; and
- Repayment outcomes and program structures that enhance a borrower's financial capabilities.

The interagency principles permit programs that use innovative technology or processes for customers who may not meet a financial institution's traditional underwriting standards and approves implementation of such programs in-house or through well-managed third-party relationships.

Core Lending Principles

The interagency principles identify the following "core lending" principles for financial institutions that offer small-dollar loan products:

- Loan products are consistent with safe and sound banking, treat customers fairly, and comply with applicable laws and regulations;
- Financial institutions effectively manage the risks associated with the products they offer, including credit, operational and compliance; and
- Loan products are underwritten based on prudent policies and practices governing the amounts borrowed, frequency of borrowing and repayment requirements.

The interagency principles warn of the risks associated with offering small-dollar loans and note the importance of lending policies and risk management practices to support a financial institution's ability to identify, monitor, manage and control such risks. The federal agencies indicate that such risk may be managed through new product development protocols that address, among other things, "the clear disclosure of terms, the risk profile of customers using the products, the use of new technologies, the use of alternative underwriting information or the use of third-party arrangements."

Areas to be Addressed in Loan Policies and Risk Management Practices and Controls

The interagency principles identify the following items that loan policies and risk management practices and controls should address in connection with a small-dollar lending program:

- *Loan structures.* Loan amounts and repayment terms should align with eligibility and underwriting criteria that promote fair treatment and credit access of applications. Product structures, including shorter-term single payment structures, should support borrower affordability and successful repayment of principal and interest and fees over a reasonable time frame rather than reborrowing, rollovers or immediate collectability upon default.
- *Loan pricing.* Loan pricing that complies with applicable state and federal laws and reflects overall returns reasonably related to the financial institution's product risks and costs. The interagency principles do not include any specific caps on interest or fees.
- *Loan underwriting.* Underwriting should use internal and/or external data sources, such as deposit account activity, and new processes, technologies and automation to reduce the cost of providing small-dollar loans.
- *Loan marketing and disclosures.* Marketing and customer disclosures must comply with consumer protection laws and regulations and provide information in a clear, conspicuous, accurate and customer-friendly manner.
- *Loan servicing and safeguards.* Programs should include processes that assist customers in achieving successful repayment while avoiding continuous cycles of debt and credit costs due to rollover or reborrowing, including timely and reasonable workout strategies for customers who experience distress or unexpected circumstances affecting their ability to pay. Such processes may also include restructuring single payment loans or open-end lines of credit into installment loan structures.

Review of Proposed Small-Loan Programs

The interagency principles note that financial institutions may, but are not required to, discuss plans for small-dollar loan products with their supervising regulators before implementation, particularly if the products constitute "substantial deviations" from their existing business plans. In addition, May 22, 2020, the CFPB issued a No-Action Letter (NAL) template, requested by the Bank Policy Institute, that financial institutions regulated by the CFPB can use to apply for an NAL covering their small-dollar loan products. The NAL template includes protections for consumers who seek small-dollar loan products. Last year the CFPB introduced a NAL policy that includes a provision regarding NAL templates, which permits applicants to secure a template that can serve as the foundation for NAL applications from companies that provide consumer financial products and services. A financial institution that obtains a NAL for its small-dollar loan products will have increased security that the CFPB will not bring a supervisory or enforcement action against it in connection with the products.

Financial institutions not regulated by the CFPB could avoid later regulatory questions or criticism by designing such programs consistent with the guardrails, features and practices set forth in the NAL applications and corresponding letters issued by the CFPB, both of which are published on the CFPB website. Financial institutions should also take into account applicable state consumer laws and, when possible, discuss their proposed loan programs with their federal and state regulators during the development stage of their small-dollar lending program. ■

[1] See, Interagency Lending Principles for Offering Responsible Small-Dollar Loans, May 2020, https://www.fdic.gov/news/news/press/2020/pr20061a.pdf. The interagency principles replace the OCC bulletin issued in May 2018, setting forth core lending principles and policies and practices for short-term, small-dollar installment lending by national banks and federal savings banks and prior guidance issued by the FDIC in 2007 (FIL-50-2007) and in 2013 (PR-105-2013), all of which have been rescinded.

[2] See, Joint Statement Encouraging Responsible Small-Dollar Lending to Consumers and Small Businesses in Response to COVID-19, March 26 2020, https://www.fdic.gov/news/news/press/2020/pr20039a.pdf.

[3] https://files.consumerfinance.gov/f/documents/cfpb_bpi_no-action-letter-request.pdf

[4] https://files.consumerfinance.gov/f/documents/cfpb_bpi_no-action-letter.pdf

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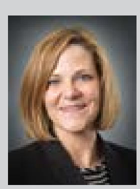

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