The State of Online Short-Term Lending

Statistical Analysis Report

Second Annual

G. Michael Flores

Bretton-Woods, Inc.

ABOUT BRETTON WOODS, INC.

Bretton Woods has served the financial services industry with senior industry and consulting professionals since 1988. The practice includes a general strategy and process improvement/earnings enhancement services in loan and deposit operations, fee income, consumer credit, payments, commercial deposit and cash management product strategies, and reengineering through enabling technologies. The firm conducts industry research with a primary focus on alternative credit and payment products.

ABOUT THE AUTHOR

Michael Flores is the CEO of Bretton Woods, Inc. and has consulted with financial services companies for over 30 years and has studied consumer credit, with a particular focus on “alternative” credit programs for the last 10 years. He has written and published research papers on consumer credit in the United States and the United Kingdom, as well as papers on payments, including general-purpose reloadable and payroll prepaid cards. Based on these studies, Flores has testified before several House and Senate subcommittees and spoken to industry groups. He has also authored articles for industry publications. He is a faculty member with Pacific Coast Banking School at the University of Washington in Seattle, Washington where he teaches a course entitled, “Retail Banking in the 21st Century.”

EXECUTIVE SUMMARY

Bretton Woods, Inc. was commissioned by the Online Lenders Alliance to conduct the second annual statistical analysis of the customer and loan characteristics of online short-term loans. The intent of this report is to:

- Analyze customer records from three specialty credit bureaus;
- Augment the credit bureau data with lender data from seven lenders to analyze both single pay and installment loan usage characteristics;
- Compare to the baseline data for single pay loans from 2014;
- Comment on the salient trends from 2012 to 2014;
- Review the migration from single pay to installment loans;
- Catalogue and understand customer demographics and loan characteristics;
- Comment on these initial customer and loan characteristics metrics; and
- Review and discuss underwriting techniques of participating lenders including the ability to repay analysis.

This is a large online study that includes:

- 15.3 million records from three credit bureaus from 2012-2014.
- 3.7 million single payment and installment loan records from seven lenders from 2012-2014.

The lenders provided the mean, median and quartile stratification metrics as well as the population of loans analyzed for the study. We have provided an average median metric to normalize the results across lenders. It is important to note that installment loan amounts and terms are determined by state law. A state-by-state analysis of installment loans may produce metrics that vary from our aggregated analysis that covers a variety of states. The following are the salient metrics of our analysis:

CUSTOMER DEMOGRAPHICS

- Single payment loans compared to last year's findings:
  - Average median age of customers has increased to 41 years compared to 39 years from the previous report.
  - The overall mean income reported by the credit bureaus last year was $30,000. This year, the average median income as reported by the participating lenders is $30,235.
  - Customers are primarily paid bi-weekly, which is consistent with last year's findings.
- Installment loans (this is the first year that we have conducted an analysis of installment loans):
  - Average median age of customers is 43 years old.
  - Average median income is $40,263.
  - Customers are primarily paid bi-weekly.

LOAN USAGE CHARACTERISTICS

- Single payment loans:
  - Average median loan amount is $428.
  - Average median loan cost is $113.
  - Average median loan term is 20 days.
  - Average median annual days indebted are 73 days.
- Installment loans:

- Average median loan amount is $667.
- Average median loan cost is $690.
- Average median term is 148 days.
- Average median annual days indebted are 135 days.

Product migration from single payment to installment loans is underway. Single payment loans are still a significant portion of the market but are declining and installment loans are increasing. Several of the lenders represented in this analysis have either eliminated single payment products or are migrating to the installment product while still offering the single payment loan.

The results of this study in conjunction with other relevant analyses do not indicate the consumer is harmed by either the single payment or installment loan. As in any population, there are outliers who may not use the products appropriately. These outliers should not be used to promulgate overly restrictive regulations that can have detrimental consequences on access to credit.

As the industry evolves, new products, expanded data and better underwriting models are allowing the industry to better serve this very significant market.

INTRODUCTION

This is the second annual report analyzing the demographics of online loan borrowers and their loan usage. While last year's study focused on single payments loans, this year's study has been expanded to include installment loans, including a discussion on the migration from single payment to installment loan products.

In the past year, numerous relevant studies, including those by Clarity Services' Non-Prime 101 Research, Navigant Economics, Urban Institute, Jennifer Priestley of Kennesaw State University and Jeffries, LLC, have reported on overall trends in consumer needs, as well as volume trends in both single payment and installments loans.

These studies have confirmed our findings: there is a noticeable migration from single payment loans to installment loans.

This year's report is influenced by the short-term, small dollar proposals released by the Consumer Financial Protection Bureau (CFPB). In general, we agree with the CFPB that there are outlier lenders who do not abide by industry standards, including the OLA Best Practices. We also agree there is a legitimate demand for short-term loan products by customers that frequently experience a mismatch between the timing of their payroll deposits and expense payments. We further recognize that many of these consumers experience unanticipated expenses that must be met. However, we are concerned that the broad brush approach by the CFPB will unnecessarily restrict access to credit for millions of Americans whose options for credit are severely limited.

KEY FINDINGS

The following chart summarizes the findings of our analysis[1].

METRIC [MEDIAN]	BRETTON WOODS' 2014 REPORT	BRETTON WOODS' 2015 REPORT [CREDIT BUREAUS]		BRETTON WOODS' 2015 REPORT [LENDERS]	
	Single Pay Loans	Single Pay Loans	Installment Loans	Single Pay Loans	Installment Loans
NUMBER OF RECORDS	60 million total applications 1.6 million loan records	15.3 million combined		2.97 million	771,909
AGE	39	39	37	41	43
INCOME	$30,000	$30,000	$34,400	$30,235	$40,263
PREDOMINANT PAYROLL FREQUENCY	Bi-weekly	Bi-weekly	Bi-weekly	Bi-weekly	Bi-weekly
LOAN AMOUNT	$300 - $500	N/A	N/A	$428	$667
LOAN COST	$51 - $125 ($17 - $25 per $100)	N/A	N/A	$113 ($26 per $100)	$690
LOAN TERM (DAYS)		N/A	N/A	20	148
ANNUAL DAYS INDEBTED	70 - 120	N/A	N/A	73	135[2]

By comparison, the Navigant study[3], which examined just over 457,000 online installment loans, reports a median borrower age of 41 years, with a median income $39,000, both of which are consistent with our analysis. The higher income levels are also supported by an analysis conducted by the Urban Institute[4].

The Navigant installment loan metrics indicate a median loan amount of $800 with a term of 203 days and a cost of $981, which is somewhat higher than our study.

For single payment loans, The Jennifer Priestley study reported the average days indebted to be 82 for storefront loans, and our analysis of online lenders shows the days indebted to be 73, both of which are significantly less than the CFPB and Pew reports of 199 days and 144 days, respectively.

[1] Detailed data analysis on file with the author.
[2] There are three primary drivers behind the days indebted being lower that the loan term. First, annual days indebted is the average amount of days customers who had installment loans out in that particular year were in debt for that year. Therefore if a customer took out a loan in 2013 and paid it off in 2014, he would have his days in debt dispersed between the two years. This causes the days in debt to be smaller than the term. Second, the days in debt would also be lower from the loan term in the event that the loan paid off early. Third, the number of days indebted was defined by the number of the days the customer was in an active loan sequence. This would mean that as soon as the customer pays off or as soon as the customer becomes delinquent, the "days indebted" clock stops.
[3] Retrieved from http://www.cfpbmonitor.com/files/2015/03/Navigant-Economics-Report-3.pdf
[4] Retrieved from http://www.urban.org/publications/2000137.html

METHODOLOGY

Bretton Woods developed a survey questionnaire for both credit bureaus and the participating lenders to capture the following:

CUSTOMER CHARACTERISTICS	LOAN USAGE METRICS
• **Age** • **Income** • **Payroll Frequency**	• Amount • Term • Cost • Number of unique loans • Number of rollovers/renewals • Annual days indebted • % of loans paid as agreed • % of loans delinquent • % of loans charged-off

We received 15.3 million loan records from three credit bureaus and 3.7 million loan records from seven online lenders. Of the seven lenders, one reported only single payment loans, two reported both single payment and installment loans, and four lenders reported only installment loan records.

In order to assure the participation of the respondent lenders, non-disclosure agreements were executed with a commitment not to identify specific companies.

The metrics were defined by Bretton Woods and the results were provided by the individual lenders. aMedian loan information was provided by participants, and thus we are reporting *average median metrics*[5] (this explains why our findings are reported as average median value rather than median value).

In an effort to establish trends and for comparison purposes, our results are compared to the results of last year's study, and to the reports released by other respected analysts.

ANALYSIS

In general, single payment loans, while still a significant portion of the market are declining and installment loans are increasing. Several of the lenders represented in this analysis have either completely abandoned the single payment product or are migrating to the installment product while still offering the single payment loan.

Each lender has developed a unique profile in terms of the products offered, the states in which they offer the products, the customer demographics and loan usage characteristics. In our opinion, this demonstrates that consumers have choices and those lenders' unique products and risk appetites have been developed to meet specific needs.

Key results of the analysis include:

- Single pay loans are beginning to decline, as consumers are migrating to installment loans. These findings are supported by the Jeffries study.
- Reported consumer income is higher for installment loans borrowers than for single pay loan borrowers. This finding is supported by other studies, including Navigant and the Urban Institute.
- The average age of borrowers is up slightly from last year's report.

[5] See http://www.incontext.indiana.edu/2013/mar-apr/article3.asp for explanation of averaging medians.

- The majority of lenders reported that loan portfolio performance improved from 2012 to 2014 for both single payment and installment loans. This is manifested in higher rates of loans reported paid as agreed and lower rates of charge-offs. Five of the seven lenders reported improved loan performance over the three year period, while one lender showed a slight decrease, and one lender only reported data for 2014.

It is our opinion that the greater use of big data and maturing of underwriting algorithms utilized by lenders is resulting in improved loan performance. Future analyses will focus on the move to installment loans to monitor loan performance.

This study is not intended to size the market, but other credible analyses shed light on this.

Many lenders reported their move from the single payment product to installment. For installment loans, the Jeffries report of public companies shows annual growth of 2.6 percent in 2014.

According to the Jeffries report[6], demand for small dollar, short-term credit remains significant with a modest reduction of 8 percent from $49 billion in 2012 to $45 billion in 2014. It is important to highlight the purchasing power multiple (amount of credit granted per dollar of cost) this data represents. The following table displays the Jeffries data and our calculation of purchasing power.

PAYDAY LOAN VOLUME ($ BILLIONS)	2012	2013	2014
STORES	$30.1	$30.0	$28.0
INTERNET	$18.6	$15.9	$17.3
TOTAL	$48.7	$46.0	$45.3
PAYDAY LOAN FEES ($ BILLIONS)			
STORES	$5.0	$4.9	$4.7
INTERNET	$4.3	$4.1	$4.0
TOTAL	$9.3	$9.0	$8.7
PURCHASING POWER	**5.2X**	**$5.1X**	**$5.2X**

For each $1 in fees, the consumer achieved $5.20 in credit to pay for their specific needs.

[6] Hecht, John, Jeffries, LLC, *The State of Short-term Credit in a Constantly Changing Environment.* Report presented to the CFSA 15th Annual Meeting and Conference.

The Navigant Economics report[7] dated March 2, 2015 reports the following online installment loan metrics and is compared to our findings:

METRIC	NAVIGANT	BRETTON WOODS
LOAN ANALYZED	457,118	771,909
MEDIAN INCOME	$39,134	$40,263
MEDIAN AGE	41.1	43
MEDIAN LOAN AMOUNT	$800	$667
MEDIAN COST	$981[8]	$690
MEDIAN TERM (DAYS)	203	148
MEDIAN NUMBER OF PAYMENTS	13.0	9.87[9]
MEDIAN BI-WEEKLY PAYMENT AMOUNT	$137	$137.49[10]
MEDIAN PAYMENT TO INCOME	8.59%	8.88%[11]

A study[12] by the Urban Institute indicated that consumers with higher incomes (above $30,000) who use alternative credit products have grown from 42 percent to 48 percent. Particularly striking is the 57 percent increase in the $75,000 income category.

	JUNE 2011	JUNE 2013
LESS THAN $15,000	30	25
$15,000-$29,999	28	28
SUBTOTAL: LESS THAN $30,000	**58**	**52**
$30,000-$49,999	22	23
$49,999-$74,999	13	14
AT LEAST $75,000	7	11
SUBTOTAL: AT LEAST $30,000	**42**	**48**

The CFPB talks about “debt traps” and the “cycle of debt” as the adverse consequences of short-term loan products. A study[13] by Jennifer Lewis Priestley of Kennesaw State University found that “borrowers who engage in protracted financing (rollover) activity have better financial outcomes (measured by changes in credit scores) than consumers whose borrowing is limited to shorter periods…while regulation has a small effect on longer-term usage patterns, consumers whose borrowing is less restricted by regulation fare better than consumers in the most restrictive states…”.

[7] Beales, III, J. Howard and Anand M Goel; Navigant Economics, *Small-Dollar Installment Loans: An Empirical Analysis;* March 2, 2015 Page 15. Retrieved from http://www.cfpbmonitor.com/files/2015/03/Navigant-Economics-Report-3.pdf

[8] Bretton Woods computed by multiplying the payment amount by the number of payments and subtracting the loan amount (principal). The authors of the Navigant study were consulted on this technique and approved the approach.

[9] Computed by taking the term and dividing by 30 days to equate to the number of months and multiplying by 2.1667 for bi-weekly payments to equate the number of payments

[10] Computed by summing the loan amount and loan cost and dividing by the number of payments

[11] Computed by dividing the annual income by 26 to equate to a bi-weekly income figure. The payment amount is then divided by the bi-weekly income amount.

[12] Mills, Gregory B., Urban Institute, *At the Recovery Progresses, Use of Nonbank Credit Rises*, January 2015, Page 2. Retrieved from: Retrieved from http://www.urban.org/publications/2000137.html

[13] Priestley, Jennifer Lewis, Kennesaw State University, *Payday Loan Rollovers and Consumer Welfare*, December 5, 2014. Retrieved from: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2534628

A chart in Kennesaw study indicates the average number of rollovers to be 5.6 in the states reviewed:

Rollovers are Defined as Within 14 Days Between Loans

	TOTAL NUMBER OF LOANS	AVERAGE COUNT OF LOANS ROLLED OVER PER BORROWER
CA	134,500	5.13
FL	112,729	5.24
KS	150,403	7.71
MO	138,672	7.07
OK	177,416	4.88
TX	92,472	5.51
UT	46,415	4.57
TOTAL:	**852,607**	**5.60**

Additionally, another chart in the Priestley study highlights the days indebted:

Payday Loan Debt Until Debt-Free 14 Days

	Number of Loans				Days in Debt				Amount Paid (Fees)			
	Mean/sd	p25	p50	p75	Mean/sd	p25	p50	p75	Mean/sd	p25	p50	p75
CA	4.29 (7.96)	1	2	4	84.60 (153.67)	14	29	96	277.90 (590.32)	45	90	244
FL	4.47 (7.80)	1	2	5	70.20 (136.67)	14	28	78	196.32 (374.61)	43	76	220
KS	6.13 (9.90)	1	3	6	99.44 (176.19)	16	39	98	289.47 (566.85)	45	101	285
MO	5.62 (8.64)	1	3	6	97.57 (160.84)	17	43	101	263.00 (489.09)	45	98	251
OK	3.77 (5.32)	1	2	4	73.19 (115.54)	21	39	84	183.58 (281.45)	50	95	210
TX	5.38 (7.71)	1	3	6	103.10 (150.59)	26	58	124	533.59 (825.40)	105	255	611
UT	3.42 (3.55)	1	2	4	51.41 (55.62)	15	31	62	285.38 (371.89)	75	152	342
TOTAL:	**4.63 (7.43)**	**1**	**2**	**5**	**82.48 (140.28)**	**16**	**38**	**92**	**285.07 (534.29)**	**50**	**113**	**293**
N	29425				29425				29425			

These metrics are lower than what was reported in the CFPB White Paper[14] and Data Point,[15] and indicates that most consumers appear to be managing their debt in such a way as to not negatively impact their welfare.

Similarly, a study[16] by Ronald J. Mann of Columbia University School of Law reveals the following:

> "The essay uses a difference-in-difference approach, comparing the credit-score change over time of those who default to the credit score change over the same period of those who do not default. The essay presents three principal findings. First, credit score changes for borrowers who default on payday loans differ immaterially from changes for borrowers who do not default on payday loans. Second, the fall in the year of the default plainly overstates the net effect of the default, because the credit scores of those who default on payday loans experience disproportionately large increases for at least two years after the year of the default. Third, the

[14] Retrieved from: http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf
[15] Retrieved from: http://files.consumerfinance.gov/f/201403_cfpb_report_payday-lending.pdf
[16] Mann, Ronald, J., Columbia University Law School, *Do Defaults on Payday Loans Matter?*, December, 2014. Retrieved from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2560005

payday loan default cannot be regarded as the cause of the borrower's financial distress; borrowers who default on payday loans have experienced disproportionately large drops in their credit scores for at least two years before their default."

Finally, we compare key metrics to other salient studies of single payment loans:

Metric	Bretton Words (Online)	Clarity (Online)	Priestley[17] (Storefront)	CFPB[18] (Storefront)	Pew[19] (Storefront)
Average Income	$30,000 (Gross)	$30,000 (Gross)[20]	$24,585 (Net)	$22,476 (Net)	72 % have a household income of less than $40,000 (Gross)
Average Age	41	Approx. 65% of customers older than 35[21]	39	N/A	52 % fall in the 25 to 44 age category.
Vantage Score	N/A	525[22]	587	N/A	N/A
Loan Amount	$428	$350	N/A	$350	$375
Days in Debt	73	N/A	82	199	144

The Priestley study calculated the annual days in debt to be 82 as compared to our analysis which indicates 73 days in debt, both of which are significantly lower than the 199 days reported by the CFPB and 144 days as reported by the Pew analyses.

[17] Priestley, Jennifer Lewis, Kennesaw State University, *Payday Loan Rollovers and Consumer Welfare*, December 5, 2014. Page 28. Retrieved from: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2534628
[18] See http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf
[19] See http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/PewPaydayLendingReportpdf.pdf
[20] Small-Dollar Markets Research Team, Clarity Services, *Profiling Internet Small-dollar* Lending, July 15, 2014. Page 7. Retrieved from: https://www.nonprime101.com/wp-content/uploads/2013/10/Clarity-Services-Profiling-Internet-Small-Dollar-Lending.pdf
[21] Ibid, Page 5.
[22] Clarity Services, Inc. Presentation entitled *Profiling Nonprime Consumers and Insight Into the Possible Effects of "Ability to Pay" Proposed Regulation,* Slide 7. Retrieved from: https://www.nonprime101.com/wp-content/uploads/2015/04/Tim-Ranney-Rick-Hacket-AFSA1.pdf

UNDERWRITING

Given the nature of low dollar, short-term loans, fraud analysis and credit worthiness are the key factors in their underwriting. Our analysis of the industry indicates that, indeed, robust underwriting does occur.

Our position is that the underwriting of short-term loans is more akin to banks granting overdraft limits to their checking account customers. A short term advance is distinctly different from a traditional consumer loan.

Veritec Solutions is a real-time, regulatory solutions provider. Veritec provides insight into traditional underwriting and its application to short-term loans, as follows: [23]

> "Credit assessment for a traditional consumer loan requires that a consumer submit information about their income along with a review of their credit reports and credit scores. Lenders assess a consumer's risk profile to determine how much they can afford to borrow based on current income, liabilities (short-term, long-term, revolving, etc.) and credit history. Terms of a credit contract (e.g., an interest rate and a monthly payment) are established based on this assessment. This entire process can take anywhere from a couple of days to a couple of weeks, and is carefully analyzed by loan experts. This evaluation comes with a significant cost to the lender and is often not practical for small, short-term loans."

Consumers use short-term loans to address unanticipated expenses and income smoothing and if these consumers could qualify for a traditional bank loan, they cannot wait for the approval process.

Underwriting Survey

Bretton Woods conducted a survey of several lenders to better understand the industry's approach to approve applications. The following represent some of the questions posed to the lenders, as well as a summary of the most common responses:

Products offered:

- Single payment
- Installment
- No open ended credit

What and how many types of data sources and data points are currently utilized to underwrite loans?

- Up to 25 distinct data sources with anywhere from 1,000 to 2,000 data points.
- One lender stated that they use Instant Bank Verification that is consumer provided. We are also looking at other tools such as "Hello Soda" for their psycho-linguistic models.
- Several lenders noted that they occasionally utilize other tools in the underwriting process to verify a borrower's identity, account number and balance in real-time.

What frequency do you evaluate your underwriting methodology?

Daily to monthly based on the sophistication of the underwriting algorithms.

What types of tools and models are used?

[23] Retrieved from: http://www.veritecs.com/small-dollar-credit-underwritten-policy-makers-cant-force/

- Traditional credit, anti-fraud, credit worthiness, trend assessments, decision trees, scorecards, internal filters and lending rules.
- The source data comes from the application and third party databases.

What are the greatest challenges in determining the applicant's ability to repay?

- Fraud detection.
- Ability to access information on other debt obligations.
- Incomplete reporting back of loan activity to the alternative credit bureaus.
-

What is your estimate of the additional costs of operating in multiple jurisdictions versus a federal charter?

Most respondents indicated that their costs are somewhere between 10-25 percent higher by operating in multiple jurisdictions. One lender indicated higher costs of 50 percent.

How would you differentiate your underwriting from traditional bank underwriting for unsecured consumer loans?

To facilitate this object we have two streams of underwriting:

- Fraud detection and prevention
- Credit worthiness

We are focused on meeting our customers need for a quick answer to their money shortfall. As result we rely on an automated decision-making algorithm that relies on traditional trade lines, payment history and the customer's declared information like income and places of employment to make a decision about the customer's willingness to repay the loan.

We look at several aspects from verification of the application including loan to income ratio, payment to income and big data, machine learning and credit scoring as part of our processes.

To what extent do you use "big data" (extremely large data sets that may be analyzed computationally to reveal patterns, trends, and associations) in analyzing loan applications?

We utilize underwriting responses from third parties such as (third party credit bureaus) which can include up to 6,000 attributes per loan application and run internal statistical analysis on this data monthly.

These survey results along with numerous discussions with other lenders indicate that a great deal of thought and investment has been made to understand the applicants' credit worthiness.

EMERGING TECHNOLOGIES

Alternative credit bureaus[24] are developing solutions that review months of bank statements to analyze both deposit trends for sources of income as well as spending patterns for recurring household expenses and other debt obligations. This and the ongoing evolution of algorithms to assess fraud and credit risk provide quite sophisticated underwriting for this market.

[24] See https://www.clarityservices.com/products/bank-account-information/ and http://www.microbilt.com/instant-bank-verification.aspx

UNDERWRITING CRITERIA

We believe that underwriting should include the willingness to repay, as well as the capacity to repay. These are the traditional underwriting criteria banks have used for decades. That is, the five C's of credit:

- **CHARACTER** (willingness to repay)
- **CAPACITY** (capability to repay as measured by income & total obligation)
- **CONDITIONS** (loan and payment structure)
- **CAPITAL**
- **COLLATERAL**

Character is the most important criterion in that it determines the person's willingness to pay their debts. In small dollar, short-term lending, capacity and conditions are also key considerations. Capacity is the ability to accommodate additional debt, given a certain amount of income and other obligations.

Conditions, such as the loan amount, payment terms, payment method, interest rate and risk appetite influence the lender's desire to make the loan and its ability to collect the loan. Capital does not apply in this type of lending because there are no borrower equity or down payment requirements, and collateral is not relevant as these are unsecured loans.

As part of the "conditions" assessment in underwriting, banks have historically asked the consumer to pick a day/date during the month to schedule the loan payment in order to assure there are sufficient funds in the borrower's account to make the payment. Merchants and other depositors of checks that are returned because of insufficient funds have and do employ similar strategies and methods to assure that when they re-deposit the check, it has the best chance of being paid.

The CFPB maintains that lenders focus on the ability to collect rather than the ability to repay. The ability to collect is not new to lending and certainly not exclusive to short-term lenders and is not unfair, deceptive or abusive.

We also believe that that "demonstrated need" should be part of any underwriting criteria. This is particularly important given CFPB's proposed waiting periods and limit on total days indebted in a twelve month period.

Verification of income and analysis of all other existing obligations is a challenge especially given the low dollar amount of these loans. This is one of the reasons most banks do not make individually underwritten, unsecured loans under $2,500. Bretton Woods has analyzed the costs to originate, underwrite, process, book, and service consumer loans for several banks.

The elements of this analysis include:

+ Interest income	**Other Data Requirements To determine minimum return on allocated capital**
+ Any fees	Average loan balance outstanding for the term of the loan (percent of initial loan)
- Funding cost	Capital to assets ratio
- Average principal loss rate (Principal/Loan Originated)	Corporate tax rate
- Average interest loss rate (Interest/Loan Originated)	Required pre-tax adjusted return on allocated capital on average loan outstanding
- Overhead allocation (% of average assets)	
- Loan origination cost	
- Underwriting cost	
- Application cost for rejected/withdrawn applications	
- Underwriting cost for rejected/withdrawn applications	
- Processing cost	
- Servicing cost	
- Collection cost	
- Compliance cost	
- Coupon book cost including postage	
= Net profit/ (loss) – Does net profit equal or exceed the required return on allocated capital?	

In one such case from a large community bank, to achieve a profitable loan repayable over twelve months, at an 18 percent interest rate, the minimum loan amount would be $4,700. At a 36 percent APR, the minimum loan amount would be $2,030 for the same term. A loan for $500 would require an interest rate of 133.56 percent over a term of twelve months. Shorter terms would dramatically increase the APR. Because of reputation risk, most banks will not make loans at these APR's.

ARBITRARY RESTRICTIONS

The CFPB's proposed rules address both short-term single payment loans with terms less than 45 days and long term installment loans with terms greater than 45 days. The following is an excerpt from the CFPB[25]:

SHORT-TERM LOANS

- **Debt Trap Prevention Requirements:** This option would eliminate debt traps by requiring lenders to determine at the outset that the consumer can repay the loan when due–including interest, principal, and fees for add-on products–without defaulting or re-borrowing. For each loan, lenders would have to verify the consumer's income, major financial obligations, and borrowing history to determine whether there is enough money left to repay the loan after covering other major financial obligations and living expenses. Lenders would generally have to adhere to a 60-day cooling off period between loans. To make a second or third loan within the two-month window, lenders would have to document that the borrower's financial circumstances

[25] Retrieved from: http://www.consumerfinance.gov/newsroom/cfpb-considers-proposal-to-end-payday-debt-traps/

have improved enough to repay a new loan without re-borrowing. After three loans in a row, all lenders would be prohibited altogether from making a new short-term loan to the borrower for 60 days.

- **Debt Trap Protection Requirements:** These requirements would eliminate debt traps by requiring lenders to provide affordable repayment options and by limiting the number of loans a borrower could take out in a row and over the course of a year. Lenders could not keep consumers in debt on short-term loans for more than 90 days in a 12-month period. Rollovers would be capped at two – three loans total – followed by a mandatory 60-day cooling-off period. The second and third consecutive loans would be permitted only if the lender offers an affordable way out of debt. The Bureau is considering two options for this: either by requiring that the principal decrease with each loan, so that it is repaid after the third loan, or by requiring that the lender provide a no-cost "off-ramp" after the third loan, to allow the consumer to pay the loan off over time without further fees. For each loan under these requirements, the debt could not exceed $500, carry more than one finance charge, or require the consumer's vehicle as collateral.

LONGER-TERM LOANS

- **Debt Trap Prevention Requirements:** Similar to short-term loans, this option would eliminate debt traps by requiring lenders to determine at the outset that the consumer can repay the loan when due – including interest, principal, and fees for add-on products–without defaulting or re-borrowing. For each loan, lenders would have to verify the consumer's income, major financial obligations, and borrowing history to determine whether there is enough money left to repay the loan after covering other major financial obligations and living expenses. Lenders would be required to determine if a consumer can repay the loan each time the consumer seeks to refinance or re-borrow. If the borrower is having difficulty affording the current loan, the lender would be prohibited from refinancing into another loan with similar terms without documentation that the consumer's financial circumstances have improved enough to be able to repay the loan.

- **Debt Trap Protection Requirements:** The Bureau is considering two specific approaches to the debt trap protection requirements for longer-term products. Under either approach, loans would have a minimum duration of 45 days and a maximum duration of six months. With the first, the proposal being considered would require lenders to provide generally the same protections offered under the National Credit Union Administration program for "payday alternative loans." These loans have a 28 percent interest rate cap and an application fee of no more than $20. With the second, the lender could make a longer-term loan provided the amount the consumer is required to repay each month is no more than 5 percent of the consumer's gross monthly income; the lender couldn't make more than two of these loans within a 12-month period.

Based on our findings and the Navigant study, the median payment to income ratio for installment loans ranges from 8.2 percent to 8.6 percent. Given Navigant's report of online loan payment to income ratio in the 25th percentile of 5.76 percent[26], it is reasonable to assume that a 5 percent maximum PTI could eliminate over 75 percent of the loans currently being made.

Additionally, an excellent research report from Non-Prime 101 entitled, "Predictive Value of Payments-to-Paycheck Ratio in Payday Lending"[27] finds that there is no correlation between the 5 percent PTI cap and the risk of default. Furthermore, the study states, "…there are a lot of borrowers with a higher PTI for whom other characteristics are more predictive of their ability to repay the loan without harm. Many of those with higher PTIs would, under the 5 percent rule, be excluded from access to credit that would be

---

[26] Beales, III, J. Howard and Anand M Goel; Navigant Economics, *Small-Dollar Installment Loans: An Empirical Analysis;* March 2, 2015 Table 6, Page 28. Retrieved from http://www.cfpbmonitor.com/files/2015/03/Navigant-Economics-Report-3.pdf

[27] Toth, Peter, Clarity Small-Dollar Markets Research Team, Clarity Services, Inc. *Predictive Value of Payments-to-Paycheck Ratio in Payday Lending.* Retrieved from https://www.nonprime101.com/wp-content/uploads/2015/02/Clarity-Services-Measure-of-Reduced-Form-Relationship-Final-21715rev.pdf

beneficial."

For both short-term and longer-term loans, we see no benefit to consumers under these proposals and can only envision substantial restrictions to access to credit to consumers who have the least options.

CONCLUSION AND RECOMMENDATIONS

As we reported in the past, it is our opinion that the single payment loan will remain a critical element in the continuum of loan products in order to give consumers the necessary options to meet their individual needs. The migration to an installment product is both the result of increased regulatory pressure on the single payment product and, importantly, recognition by lenders that the single payment loan is not appropriate for some consumers who need more money and/or time to pay the loan back.

The additional requirements to underwrite for the ability to repay proposed by the CFPB should consider new analytical tools being utilized by the industry that assess credit risk for this market. Rather than relying on old budget-based, pre-big data analytical tools, the industry has developed sophisticated algorithms that are continually being updated for adequacy to confirm the borrower's identity, detect fraud, validate the age of deposit accounts, access data from the traditional credit bureaus and detect IP addresses of computers used to apply for credit to mitigate fraud among many other salient data points.

It is our belief that for unsecured short-term credit, verifications of employment/income and total debt obligations similar to mortgage loan underwriting are not authorized by the Dodd-Frank Wall Street Reform and Consumer Protection Act and are uneconomical for small dollar loans. The costs for these additional metrics will put cost pressures on many small lenders, some of whom may not be able to sustain their business models because of these costs.

We suggest that underwriting should include willingness to repay as well as capacity to repay. This is similar to the traditional underwriting criteria banks have used for decades. That is, the five C's of credit: character, capital, capacity, conditions and collateral. Character is the most important criteria in that it determines the person's willingness to pay their debts. In small dollar, short-term lending, capacity and conditions are also key considerations.

We also recommend that the CFPB allow lenders to consider "demonstrated need" by the borrower to help drive the underwriting decision. That is, if a borrower has had three short-term loans and is in the proposed "sixty day waiting period," the borrower should be able to present their case that the need for credit is justified because the benefit of the proceeds of the loan exceeds the cost of the loan. For example, if the consumer must pay for a car repair that is critical for the consumer's ability to get to work and earn a living, then forbidding that consumer to access credit would create much greater harm than the cost of the additional loan.

Finally, we disagree with the other arbitrary restrictions on access to credit. Our research and other studies cited in this report do not find correlations with loan usage and payment to income characteristics as being predictive of loan defaults. We do find that these restrictions will reduce loan volume by approximately seventy five percent and deny these consumers legitimate access to credit.

We trust the CFPB will consider the unintended, but not unanticipated, consequences of its initial proposals as the agency undertakes a formal notice of proposed rulemaking.