

# Back to the Bank for Small-Dollar Loans

In a turnabout driven by the economy, customers are coming back to insured financial institutions as a more secure and reliable source of banking services. Understanding that these transitional customers represent a relationship-building opportunity for the future, alert financial institutions are taking a serious look at the market for small-dollar, short-term, unsecured loans.

In many cases, prospects for small-dollar loans are already customers, having opened basic checking accounts at insured depository institutions in order to seek access to emergency funds from nontraditional financial services providers. These forays often result in high-cost loans and cash advances from storefront money services, Internet credit vendors, and other nonbank providers, many of whom tout their credit products as “cheap,” “faxless” (no need for the applicant to fax paperwork), and in many cases, requiring no credit check. By some estimates, up to one-fifth of bank account holders use “payday lenders” for their emergency borrowing needs. The onerous costs and risks associated with many of these products have not deterred users because such loans are not readily available from mainstream financial institutions.

The Federal Deposit Insurance Corporation (FDIC) is concerned about the predatory aspects of high-cost loans flooding the market and has issued guidelines to banks on extending affordable, small-dollar loans. The FDIC is also in the midst of a two-year pilot program to identify effective, affordable, and replicable small-dollar loan programs that can be incorporated on the menu of traditional banking products. The FDIC’s goal is to move many of the millions of customers who use short-term

loans back to the safety and security of insured institutions.

The question is: Where does this public policy goal converge with the profit and customer service objectives of a private financial services enterprise? Preliminary results of the pilot program suggest that small-dollar loans can be profitable if properly structured and are an effective means of attracting and retaining customers and creating opportunities to cross sell other products. One pilot bank reports that virtually all of its small-dollar loan customers have added checking accounts and debit cards, and some have opened linked savings accounts, certificates of deposit, and individual retirement accounts. One participating bank approves an automobile loan for customers who successfully repay their initial small-dollar loan.

The FDIC pilot program is scheduled to continue through the fall of 2010, but a few forward-thinking institutions have looked at the preliminary data and are convinced that early adoption of small-dollar loan products will give them a head start in winning future market share. For them, a brand new technology solution called *InstantAdvance*™ has come along at just the right time to enable them to profitably serve the immediate, short-term cash needs of existing and prospective customers without undue exposure to credit, operational, or reputation risk.

*InstantAdvance* supports an open-end credit line governed by the Truth in Lending Act (TIL) and Regulation Z and tied to a customer’s checking account. Created by Sheshunoff Consulting + Solutions (SCS) as an adjunct to its Deposit Score® suite of products, *InstantAdvance* enables financial institutions to safely extend small-dollar, short-term deposit advanc-

es while gaining a new source of interest income. It also offers customers an alternative to ongoing overdraft services, giving them maximum flexibility to meet their unforeseen financial needs.

From the important perspective of customer well being, *InstantAdvance* is not a “payday” product. Instead, the program gives customers a practical means of implementing financial advice that the FDIC has addressed to all consumers: instead of waiting until they are in a rush for cash, they should set up, in advance, a regulated, pre-approved account that will provide access to reasonably priced emergency credit when and if they need it.

## AHEAD OF A TREND

*InstantAdvance* is a conservative, best practices tool that enables financial institutions to meet their customers’ emergency cash needs through automated deposit advance services while carefully managing risk and exposure. The program continuously scores accounts, tracks behavior, monitors usage patterns, identifies high-risk customers, and makes dynamic adjustments to the overall credit limit for each account.

With this innovative technology solution, insured financial institutions are getting out ahead of a trend and achieving important business, strategic, and customer service goals:

### 1. Harness a New Revenue Stream

*InstantAdvance* brings existing customers “back to the bank” by offering a regulated, transparent, and reasonably priced credit line tied to a checking account, opening up a new source of revenue from customers with whom the institution already has a relationship. As that relationship expands, so do cross-sell opportunities as previously underserved customers begin to see the institution as their best full-service source for financial services.

### 2. Gather in New Customers

People who use high-cost nonbank providers for short-term credit needs represent an up-and-coming customer segment. Typical

customers are middle-income, educated, and fit the economic profile of consumers in their early life-cycle stages. Emergency cash borrowers also include those who are experiencing temporary reductions in income or unexpected expenses. In time, a large portion of these customers will have stable jobs and higher incomes, and their financial services business will be in great demand.

### 3. Offer Quick, Secure, Convenient Access

With *InstantAdvance*, customers acquire checking account advances through online banking, telephone banking lines, call centers, ATMs, or mobile banking. These multiple points of access offer them convenience, confidentiality, and security — all attributes that they appreciate and remember when they need other products and services. In addition, the automated underwriting process cuts costs for both the institution and the customer and virtually eliminates the waiting period for established customers. Rapid approval is a matter of considerable importance to the emergency borrower.

### 4. Improve the Customer Experience

SCS’s intent in developing a depository institution-based, small-dollar lending program is to provide transparency and fairness to good customers who encounter emergency credit needs. It is designed to empower customers to better manage their accounts, avoid unnecessary costs and risks, and avail themselves of reputable, regulated institutions for the whole scope of their banking and credit needs.

### 5. Address Safety & Soundness and Compliance Issues

As with any part of an institution’s loan portfolio, management is concerned about complying with minimum capital requirements, managing credit concentrations, and maintaining an adequate allowance for loan and lease losses. *InstantAdvance* supports these safety and soundness requirements and is compatible with the examiners’ Retail

Classification Policy and guidelines for renewals and rewrites, recognition of accrued fees and finance charges, and loan recovery.

The software and related regulatory consulting services also facilitate compliance with the panoply of federal laws and regulations, including TIL/Regulation Z, Community Reinvestment Act, Equal Credit Opportunity Act/Regulation B, and others.

#### 6. Apply Risk Management Controls

*InstantAdvance* is an integrated application that is highly complementary to SCS's Deposit Score overdraft solution installed at some 130 financial institutions throughout the country. The application can process either independently or in tandem with Deposit Score and takes advantage of built-in risk management, reporting, and profit enhancement features. It also imports loan advance activity to develop a complete risk-based picture of a customer's transactions.

SCS's technology experts are currently developing empirically derived insights into the income and retention outcomes presented by short-term borrowers versus overdraft users to help guide an institution's growth and risk management strategies.

#### 7. Access Expert Implementation and Management Resources

SCS surrounds the *InstantAdvance* program with services and resources that manage execution risk, contain costs, optimize interest income, and comply with the

relevant laws and regulations. Among these services and resources are technology implementation (project management, software integration, installation, and pre-live analysis), best practice recommendations, regulatory guidance, sales and marketing, and consulting services that tailor each institution's checking account advance program to its own set of business strategies. *InstantAdvance* also entails ongoing program management and analytical services, including peer comparisons and performance reporting.

These features are backed by SCS's experience and reputation as a conservative provider of expert consulting on safety and soundness issues and risk management solutions.

#### IN THE MOMENT

The federal and state regulatory agencies are likely to continue encouraging regulated institutions to develop and offer small-dollar, short-term, unsecured loans. With *InstantAdvance*, these institutions have an opportunity to reduce customer reliance on high-cost, nonbank service providers by becoming more active in making reasonably priced, small-dollar loans available to customers who need them. It is an opportunity unique to the moment that can generate earnings and create and solidify customer relationships well over the horizon.

**For more information go to [www.smslp.com](http://www.smslp.com) or call 1.800.477.1772**