USBanker

November, 2010

By Laura Thompson Osuri

It didn't take long for Citizens Trust Bank in Atlanta to learn how difficult it is to make money on short-term loans to cash-strapped consumers.

In late 2007, Citizens was one of 28 banks the Federal Deposit Insurance Corp. selected to participate in a two-year pilot program designed to determine if banks could make small-dollar loans profitably. By the fall of 2009, with default rates on its small consumer loans approaching 13 percent, Citizens dropped out of the FDIC program.

Still, the $394 million-asset Citizens hasn't given up on small-dollar lending-and a provision tucked into the Dodd-Frank Act might be just the motivation it needs to try once more.

The legislation sets up a government-backed fund that certified Community Development Financial Institutions like Citizens can access to help cover losses on consumer loans of less than $2,500. There's little doubt that a need for small-dollar loans exists-banks that participated in the FDIC pilot originated more than $40 million of loans in a two-year period-and Sharnell Reynolds, Citizens' director of consumer lending, says that a federally backed loan-loss reserve fund "could be the incentive we need" to start making them again.

As with the FDIC pilot, the aim in creating the loss-reserve fund is to encourage more banks to make small, short-term loans to consumers who typically turn to payday lenders when money is tight. According to a recent study from the Center for Financial Services Innovation, about 40 percent of the million U.S. households considered to be unbanked or underbanked borrowed money last year from payday lenders, pawnshops, tax-refund anticipation lenders, or friends and family to cover basic living expenses. That's not including higher-income consumers who might have borrowed $1,000 here or $2,000 there to cover unforeseen expenses.

Vikki Frank, the executive director of the Credit Builders Alliance, a Washington-based consumer advocacy group, says a lot of lenders are reluctant to make small-dollar loans because they "don't know how." The loan-loss reserve fund, she says, "gives them a little more confidence to take risks and be more innovative without worrying so much about the balance sheet."

The fund is expected to be up and running by the middle of 2011, once Congress appropriates the money to seed it.

Other details are still being worked out. For example, the legislation allows banks and credit unions not certified as CDFIs to access the fund if they partner with a CDFI, but it's how such partnerships might work. The legislation also does not specify rates or terms, though it is likely lenders will be free to design their own programs as long as the loans don't exceed a certain rate. (Under the FDIC pilot, banks were required to keep the annual percentage rate below 36 percent.)

Congress is expected to appropriate $7.5 million to start the fund and participating lenders will be required to provide 50 cents in matching funds for every dollar in aid they receive. In all, the fund is expected to generate roughly $100 million in small-dollar lending.

James Gutierrez is the chief executive officer of Progreso Financiero, a CDFI in Mountain View, Calif., one of the country's largest small-dollar lenders. Though Progreso has about $50 million of the loans outstanding, Gutierrez says the total needs to be around $75 million for the program to be consistently profitable. Access to the government-backed fund would move Progreso closer to that goal, he says. It could also help Progreso and other CDFIs attract equity investments from the private sector, spurring even more loan growth.

“For small-dollar lending to be successful you need scale and for scale you need sustainability,” Gutierrez says.

Melissa Koide, the policy director at the Chicago-based Center for Financial Services Innovation, agrees that the fund will help CDFIs ramp up their consumer lending. “There are some great CDFIs out there that have started doing work on small-dollar loans and access to this will help them scale up their business and show it is a viable option,” she says.

Technical assistance grants are also available to CDFIs that are interested in establishing small-dollar loan programs.

Still, while Koide calls the creation of the fund “a healthy start,” she is concerned that it could be depleted quickly as consumer demand increases and more lenders try to get into the small-dollar lending business.

Some also question why the program isn’t more easily accessible to mainstream banks, particularly in light of a report from the FDIC on its pilot program, which concluded that “the primary obstacles to entry are the cost of launching and maintaining the program and concerns about defaults.” (The average default rate for banks that participated in the FDIC pilot was 9 percent.)

El Banco de Nuestra Comunidad, a division of $447 million-asset The Peoples Bank in Winder, Ga., has been offering small loans since 2002 and has made a total of about $10 million of them since, according to Luz Lopez Urrutia, the bank’s president.

Urrutia notes that community banks that aren’t certified as CDFIs are well positioned to offer small loans because they know their customers personally and can make those often difficult underwriting decisions. “The loan loss reserve fund is a valuable first step, but I would love to see more inclusion,” Urrutia says. “Consumers have a need for these products and we as financial institution must do more to meet this need.”