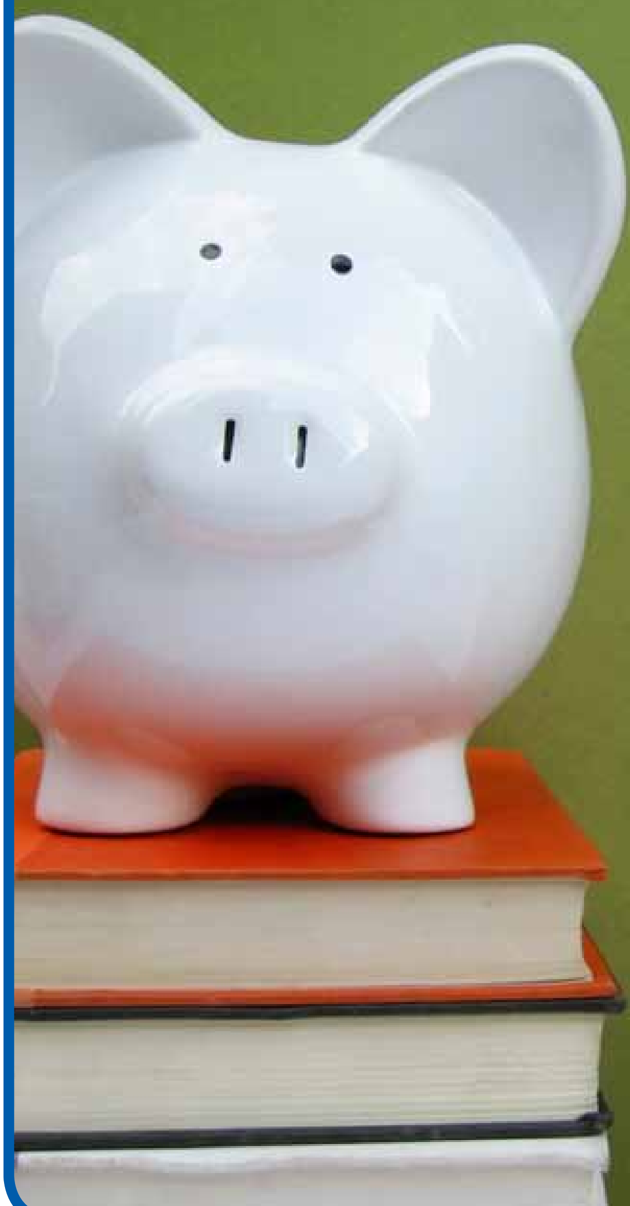
Common Cents Financial Initiative

Designing an Effective and Viable Alternative to Payday Lending:

Lessons from the Save It! Loan



by the Mountain Association for Community Economic Development

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Designing an Effective and Viable Alternative to Payday Lending:

Lessons from the Save It! Loan

In pursuing its mission to generate and protect wealth among Central Appalachian people, the Mountain Association for Community Economic Development (MACED) took on the challenge of designing an alternative to predatory payday lending. We offered a credit and savings product through employers to affordably meet the needs of low-income consumers. More than four years of research and lending operations produced useful lessons on how to structure and provide small-dollar loans and practical financial education to low- to moderate-income borrowers.

MACED offers these lessons to help others design effective and viable small-dollar loan products that build financial security.

Payday Lending in Kentucky

In an economy marked by more than 30 years of stagnating wages for low- to moderate-income workers, demand for short-term, small-dollar credit climbs each year. From the late 1980s through the 1990s changes in state-level policy allowed new financial institutions, operating outside of traditional usury statutes, to emerge. These businesses make a profit meeting low-income workers' demand for cash.

Payday lenders prey upon financially fragile communities. Their storefront presence in small communities offers easy access but saddles low- to moderate-income borrowers with unrealistic repayment terms resulting in exorbitant fees. Average borrowers flip one loan nine times, paying $472.50 in fees for a $350 loan.[1] This drains family assets making borrowers even more vulnerable to economic downturns and personal crises.

The Brookings Institution's 2007 study *The High Price of Being Poor in Kentucky* found that the market for these high-priced services is vast and grew by 121 percent between 1999 and 2006. Prior to a 2009 licensing moratorium, new payday lenders opened at a rate of one every four days, and in 2008 alone collected an estimated $158 million in predatory customer fees.[2]

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Annual business client surveys first alerted us to business' struggles when assisting cash-strapped employees through payroll advances. MACED staff interviewed business owners, reviewed research on lost productivity due to financial stress, and assessed consumer lending and savings models as approaches to stabilizing employee finances. When a payday lender moved in across the street, MACED mobilized to launch an affordable source for employee loans.

MACED staff developed a savings-builder loan program concept and raised capital and start-up funds from foundations. We explored the concept with lenders who could hold savings deposits and offer credit services to employees. MACED developed detailed business processes with the help of financial services consultants. An Internet interface was developed to accept on-line loan applications and to facilitate collaborative operation of the program among MACED, partnering lender(s) and the administrative liaisons at participating employers.

In 2006 MACED and the Appalachian Federal Credit Union (AFCU) finalized a partnership to pilot Save It! Loans with employees of participating businesses. AFCU administered loans and held employee savings accounts. MACED raised funds for the program, recruited and oriented employers, collected evaluation data and guaranteed Save It! Loans, funded by AFCU, against defaults.

Save It! Loan Overview

MACED's Save It! Loan product provided short-term loans at a fraction of the cost of payday loans. In addition to providing emergency cash, the Save It! Loan addressed borrowers' underlying need for increased financial stability by embedding a savings program in the repayment terms and providing financial education opportunities for borrowers.

From the time of the pilot's launch in May 2007 through September 2009, the program extended 410 loans totaling $133,350. Auto-deductions placed $66,650 in consumer savings accounts.

Save It! Loan

- Offered through employers.
- Repaid via payroll deductions.
- Included an automated savings component and access to best financial practices support and education.

Initial Loan Terms

- $300–$500.
- 18% interest.
- 10-month term.
- Savings accumulated to 50% of the loan value by the end of repayment.

MACED planned to build on the pilot and roll out an expanded and improved version of the product aimed at covering 10,000 employees. However, cost concerns and difficulty recruiting additional financial institution partners amidst the recession led us to discontinue pilot lending in September 2009 and cancel the expansion. Our hope is that sharing the following lessons learned will help others design and implement effective and viable alternatives to high-cost payday loans.

Lessons

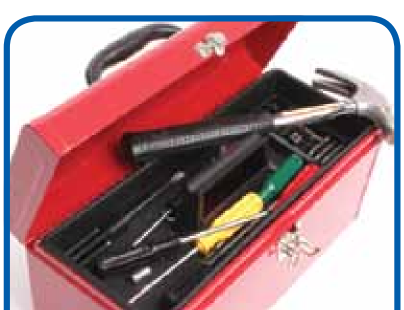
Strong product design combines features.

By combining borrowing, saving and educational features, the Save It! Loan met needs for both short-term credit and long-term financial strength. Loans had automatic savings embedded in repayment. The program provided financial education through paycheck stuffers, web-based lessons and a phone-based consumer counseling service. Borrowers liked the low cost and the savings feature. Funders and consumer advocates praised the asset-building behavioral component. Employers recognized the product and the financial education as valuable benefits for their employees. Combining these features improves convenience and efficiency while helping consumers build assets.

Loan terms and education features should be flexible to meet varied client needs.

Borrower feedback and staff observations indicated interest from consumers in a range of flexible options or terms that could be custom-fit to suit borrower needs and financial goals.

Many borrowers needed more than $500. Some renewed their loans just to accumulate savings and others wanted the option of shorter-term loans. MACED modified the Save It! Loan terms in our proposed program redesign based on this feedback and ongoing research into best practices. Given recent increases in the minimum wage our redesigned beta phase product increased the loan limit to $600.



Redesigned Save It! Loan Terms

- $375 to $600.
- 18% interest.
- Term ranges from 4-10 months.
- $20 application fee.
- Minimum savings equal to 30% of the loan value by the end of repayment.
- Savings-only option.

We also redesigned the product terms to be flexible. Clients would have been able to choose from a four to 10 month timeframe for payback, based on a self-assessment of their income sources and obligations. Participants also expressed interest in a savings-only option without taking out loans.

Online financial education opportunities were underutilized despite the fact that borrowers indicated interest in accessing these resources. This plus advice from other programs led us to consider individually customized financial education. Programs can engineer customer encounters and documents so that every contact reinforces best financial practices and adapts information to the client's situation. For example, statements can reinforce motivation by commending a client's progress toward their previously stated savings goal.

Loan access through employers reduces cost and leads to other rewards.

In partnership with MACED, employers offered the Save It! Loan as an employee benefit. MACED staff introduced the loan offering and distributed financial education materials to all employees. Those that were employed for at least six months were eligible for loans. On-site coordinators (usually human resources (HR) staff) assisted employees in the loan application process. Upon submission of an online application, employers verified the applicant's identity, employment status, income and tenure. Employees repaid loans and built savings through auto-deductions from their paychecks.[3] MACED staff provided additional customer service throughout the process.

Using employment as a proxy for underwriting and loan security lowers lending costs. Auto-deductions guaranteed timely payments. The savings from this approach benefit all participants. Marketing costs shrink because all potential customers can be reached through the workplace. Using employment tenure for underwriting and auto-deduction repayments for security further minimizes costs and defaults. In the Save It! program these savings were passed on to borrowers through lower interest rates.

Employees benefit from more affordable loans as well as easy access and confidence in the program.

> *"I trusted the Save It! Loan because it was offered by my employer. We all sign a strict confidentiality agreement with the organization so I never worried about whether my personal information was being used incorrectly."—Borrower, Eastern Kentucky Child Care Coalition*

Employers benefit when employees are not distracted by financial concerns. Throughout the pilot, feedback from employers was consistently positive.

> *"We are grateful for the benefit the Save It! Loan has brought to our employees—we see how beneficial it is on a daily basis." —Coordinator, Patriot Industries*

Lenders benefit significantly wherever they streamline operations to take advantage of Save It! model efficiencies. The cost savings in the Save It! Loan allow lenders to serve a market they might not otherwise participate in, and break even at lower loan volumes. Lenders develop relationships with businesses and individuals who can potentially migrate to higher-value products and services.

Systems to manage employment separations are critical in employment-based lending.

When payroll deductions are the vehicle for repayment, predefined contingencies for managing job changes become vital. The Save It! Loan expected borrowers to arrange for repayment if they were to leave their job. A number of situations interrupted loan repayment and inflated apparent loss rates, later found to be caused by temporary administrative delays or illness-related absence. In cases of permanent separations, lack of notification from employers increased the potential for losses when new contact information or alternative payment arrangements were not finalized as part of the exit process.

For employment-accessed lending to work well, employers should alert all partners immediately to issues that will interrupt repayment. Contingencies for temporary delays or payment interruptions allow for life events without impacting borrowers' credit scores.

Acceleration of loans could further limit losses when people leave their jobs. Loan documents would explain that employees can transfer their repayment deductions to a new employer if arranged in advance of leaving. If employees did not make arrangements, the lender would accelerate the loan and employers would withhold balances from final pay checks when employees left.[4]

An online platform broadens access and automates lending and communications.

The Save It! Loan used an online platform to give all partners and borrowers ready access to information and borrowing transactions. The web platform allowed for online loan applications and automated the processing of loans. Free financial education information was available and loan status information was visible to partners and borrowers. The Save It! Loan platform worked well for employer coordinators. Coordinators assisted borrowers with applications, if needed, and verified identity and employment status for those who applied. Once loans closed, the coordinators received email alerts specifying the details for payroll deductions. Accessing the Save It! site at work and through the employer's computers provided access to the application for borrowers without computers at home. However, lack of computer access limited those borrowers' ability to take advantage of the online financial education components of the program.

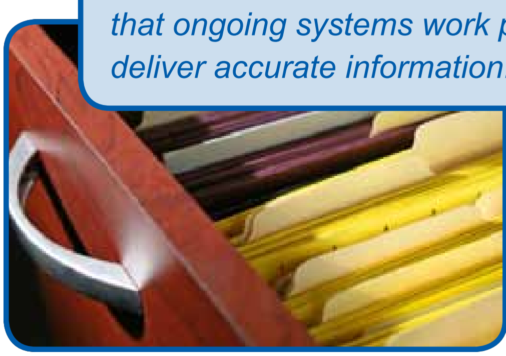
> *"The HR office sent me the link. I visited the site and read and researched the site…then I applied for it online and the steps were very easy to follow… I brought a copy of my driver's license to HR and two days later I got my money." —Borrower, Southeast Telephone*

Efficient and effective program delivery requires deep systems integration among partners.

The Save It! Loan model involves functions typically fulfilled by several different types of institutions. Delivering services across multiple organizations presents significant coordination challenges. Aligning processes drives management costs during set-up in particular. Clear systems requirements are needed for partners, who in turn need strong technical systems to leverage Internet capabilities. MACED tapped skilled consultants and programmers with specialized expertise in developing banking systems.

Once well-defined processes are integrated in software and available through the Internet, partners should be equipped to provide informed customer service. Each partnering organization can focus on their assigned or specialized roles, yet still have visibility to information generated by other partners. Managing partners need adequate in-house tech skills to maintain systems and recognize data irregularities.

> *While systems integration can be facilitated by outside programming expertise, in-house staff need enough data management expertise to verify that ongoing systems work properly and deliver accurate information.*



When partnering organizations are aligned in their objectives and use integrated systems, they invest in troubleshooting and continuously improve the program. All program partners benefit from the lower cost and smooth function of well-coordinated operations.

The Save It! Loan pilot did not benefit from the full range of potential platform efficiencies, as the partnering credit union had neither Internet interface capability nor online banking services at the time. While the credit union planned system upgrades, they were repeatedly postponed. During the entire pilot, loan servicing was off-line and manual once qualified applications left the Save It! Loan web platform. This compromised the ability of staff at either organization to respond quickly to questions, or to detect administrative glitches.

For a sustainable and scalable program, the operating costs of the partners cannot exceed the revenue available to the whole. Revenue per Save It! Loan would average about $40 in the redesigned, fully integrated version.

> *A $410 loan with a $20 application fee and a six month term at 18% interest yields $40.98 in total revenue.*

If transactions are automated and systems integrated, partners have the potential to cover their operating costs. This hypothesis has yet to be validated. The pilot data systems were not fully integrated and the redesigned Save It! model was not launched.

To be predictive, pilots should model all significant program elements.

A business adage says 'You get what you measure,' and the Save It! Loan pilot illustrated the point. The three primary program elements tested were well-developed and successful.

The goals of the pilot were to assess:

1) **Employer interest in offering loan access.**
2) **Employee demand for employment-based loans.**
3) **Applicability of an online loan application process to lending in Appalachia.**

The pilot determined unequivocally that there was significant demand and leverage available on each of these scores.

At the same time, functions and performance measures outside the main pilot focus were neither fully developed nor measured until preparation for scaling into a new version of the Save It! Loan was underway. In hindsight this proved problematic.

The pilot didn't model the incentive structures that would operate in an expanded program. MACED provided loan loss guarantees to its credit union partner during the pilot period. Since the pilot lending partner bore no financial risk, collections efforts were minimal. The resulting pilot losses of eight percent were high by traditional lending standards. Profitability wasn't a focus during the pilot phase. For instance initial pricing did not cover the costs of lending and operating the program. Redesigned loan and partnering terms projected covering operating and overhead costs for all partners as volumes increased. However, these estimates have yet to be substantiated. Our experience and research suggest that small-dollar loans offered by partners with complementing abilities and interests can meet consumer needs and cover program costs.

However, new prospective lending partners equated pilot performance with future expectation. This did not account for likely improved performance among Internet-integrated partners. In addition, the Save It! redesign included provisions for loan acceleration in case of employment separations, addressing the primary source of defaults under the original pilot design.

In general, pilots need to model all the performance measures, incentive structures and information flows anticipated in the mature program. Had the Save It! pilot incentive structure given all partners a financial stake in the outcome, each would have been more motivated to improve loan performance. Had the pilot focused on profitability measures

The program's design helped the borrower develop positive behavior changes, like developing a savings nest egg.

throughout, corrective measures would have been implemented all along. The improvement in loss rates over time would have made the pilot more predictive of loan performance in an expanded, redesigned program.

Regulatory guidance would equip financial institutions to provide low-cost, small-dollar loans.

MACED expected that banks and credit unions would be able to decipher the regulatory issues around offering the Save It! Loan program on behalf of their institutions. However, many local and regional institutions rely on national services like Bankers Systems for regulatory due diligence, forms and pre-packaged software. They value turn-key programs from their software vendor above the opportunity to customize a program to their operations and local needs. MACED also found local lenders' interpretations of regulations to be far more limiting than, and often in sharp contrast to, the interpretations and guidance received directly from regulators. The reasons for this discrepancy are unclear.

The response of financial institutions to the proposed expansion was also a function of timing. During this recession, financial institutions have been conservative in extending credit and expanding programs. The coincidence of the recession with our search for additional lenders diminished potential partners' receptivity.

Any small-dollar, short-term loan program operator would benefit from definitive regulatory guidance. This regulatory assistance could come from lending partners willing to proactively develop the regulatory provisions to accommodate a precedent-setting program. A greater investment on the part of a nonprofit in developing legal expertise for the context of each type of potential partner may fill the need. Regulators also have an important role to play in supporting the development of models for these new and innovative products. Financial institutions need examples and regulatory guidelines that allow them to venture into this new lending territory with confidence.

Diverse institutions could offer savings-builder loan products.

Several alternative types of organizations could lead in developing employer-based lending and savings programs.

Banks and credit unions could operate the entire Save It! Loan model in-house.

Banks and credit unions offer loans and depository savings capabilities essential to any savings-builder loan program. Because they offer numerous loan products, the staff, technological and facilities overhead can be shared among multiple product offerings. These financial institutions may be motivated to add savings-builder products that attract clients who are good credit risks and likely to migrate to more profitable financial products.

Save It! Loan Program Component	Could be Provided By
Savings accounts	Depository financial institution
Consumer loans	Depository or consumer lender
Internet platform	Applications or IT developer, in-house IT department
Employer recruitment	Benefits or payroll company
Situational financial education messaging	Credit counseling, nonprofit or lender with strong marketing outreach

Other organization types can offer employment-based lending through partnerships.

A partnership of two or more organizations is necessary to cover the Save It! Loan program elements for any non-depository organization. As a nonprofit community developer, MACED invested in an Internet platform and leveraged depository and consumer lending capabilities of a credit union to pilot Save It! Loans. Consumer lenders, employee benefit or payroll service companies, and credit counseling

services each offer products or services that were incorporated into the Save-It! program. A solid program might revolve around one primary institution or be a hybrid of partnership arrangements that capitalize on the strengths of multiple organizations. A successful savings-builder program is feasible where capable partners can cover program elements and costs among them, and can leverage the strengths of each partner.

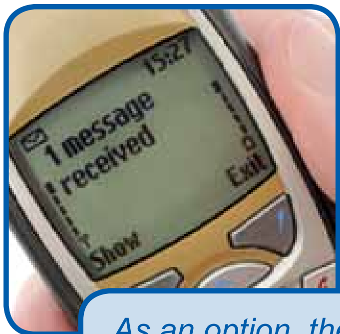
To be successful all partners must:

1) share a strong interest in this model.
2) see value in the program for their organization.
3) have technological capacity to interface with an online platform.
4) consider serving low-income people compatible with their mission.

To offer an employer-based product in Central Appalachia, technologically capable, mission-driven credit unions or banks need to step into this market. A single financial institution able to offer employer-based, savings-builder loans will have a cost advantage over partnerships.

Context matters.

While having all the requisite capabilities enables organizations to offer savings-builder loans, it does not guarantee success. Factors that shape product and program design will vary according to characteristics of the service area and target population. Products and services must be adapted to the state policies, infrastructure, demographics and culture of the locality in which they are marketed.



As an option, the Save It! Loan system notified borrowers of next application steps and status via mobile phone text messages.

Few financial institutions in Central Appalachia serve a large geographic area nor are there region-wide credit unions. The technological and new business process requirements of trying to offer the Save It! Loan regionally are significant. These factors increased the cost and challenge of assembling enough financial institution capacity to generate break-even loan volumes in Central Appalachia.

While Internet access can diminish effects of geographic isolation, not all borrowers have computers or email accounts. Many rural areas lack broadband service and Internet usage lags among rural and low-income populations nationally. Save It! Loans addressed this access challenge with the help of employer coordinators who had computer access at each participating employer.

Save It! Loan borrowers more commonly used cell phones than computers. Emerging technology applications can help programs serve hard-to-reach consumers. The key is to understand which technologies are most used by the targeted participants.

Product and program design need to include attention to local context, capacity and culture. An effective and efficient program will marry a strong product with an implementation structure that works for the people and places that it serves.

Moving Forward

In an economy struggling to recover from the worst recession since the Great Depression families need access to affordable small-dollar credit that will help them build financial stability. States and the federal government seek to reign in high-cost lending and protect consumers from future disruption to the financial system. Changes in regulation and incentive structures may help traditional financial institutions in Appalachia and around the U.S. find their way back to offering affordable small-dollar credit.

Our experience and research suggest that financial institutions can also use creative partnerships with employers to offer low-cost, small-dollar loans with flexible terms, financial education and savings benefits. Employer-based loan programs may offer a path for banks and credit unions to meet the small-dollar credit needs of low-income borrowers, while helping them build wealth and financial security. We hope these lessons prove instructive along the way.

End Notes

1. Kentucky Coalition for Responsible Lending. 2010. “The Debt Trap in the Commonwealth.” Frankfort, KY: KCRL (http://www.maced.org/files/KCRL_IssueBrief_med-res.pdf). Calculation based on average loan size nationally and average interest rates for Kentucky as reported by The Center for Responsible Lending. 2006. “Financial Quicksand” (www.responsiblelending.org).

2. Kentucky Coalition for Responsible Lending. 2010; Matt Fellowes, Terry Brooks, Valerie Salley and Mia Mabanta. 2007. *The High Price of Being Poor in Kentucky: How to Put the Market to Work for Kentucky’s Lower-Income Families.* Washington, D.C.: The Brookings Institution.

3. Organizations working in states that prohibit pledging payroll allocations can use automated transfers from employee checking accounts.

4. This does not constitute legal advice. The approaches discussed in this article must be reviewed by legal counsel for their applicability to specific situations and locations.

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MACED works to improve the quality of life in Kentucky and Central Appalachia by creating economic opportunity, strengthening democracy and supporting the sustainable use of natural resources. We are a multi-strategy community economic development organization committed to equipping entrepreneurs, communities and change agents with the tools they need to build stronger economies that work for low-income people and places in need.